Successful Stock Signals for Traders and Portfolio Managers

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Successful Stock Signals for Traders and Portfolio Managers

Integrating Technical Analysis with Fundamentals to Improve Performance

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Cover design: Wiley

Published by John Wiley & Sons, Inc., Hoboken, New Jersey.

Published simultaneously in Canada.

Library of Congress Cataloging-in-Publication Data:

Lloyd, Thomas K., 1937-
Successful stock signals for traders and portfolio managers : integrating technical analysis with fundamentals to improve performance / Thomas K. Lloyd, Sr.
pages cm. — (Wiley trading series)
Includes index.
ISBN 978-1-118-54452-5 (cloth); ISBN 978-1-118-65200-8 (ePDF);
ISBN 978-1-118-65191-9 (ePub)
1. Stock options. 2. Portfolio management. I. Title.
HG6042.L586 2013
332.63′2042—dc23

2013004419

Printed in the United States of America.

10 9 8 7 6 5 4 3 2 1

To Eileen

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Preface

The only purpose of this book is to help you improve your performance in the stock market using technical analysis as step 1 and fundamentals as step 2. Our approach will always seek to make the book a "mountain climber" because learning to invest and trade stocks is an adventure. Any book on the subject should be exciting and challenging. These qualities are appreciated by every audience, whether professional, educational, small investor, or trader. To accomplish this ambitious objective we will always subordinate the instructions on esoteric technical signals to the more fascinating discussions of individual stocks, and how technical analysis signals would have enhanced your gains in trading or investing in the market using fundamentals.

Traders already know the importance of using technical analysis, but many investors have yet to learn. Traders are forced to use technical analysis because fundamental analysis often does not explain the price movements of stocks in the short term. Technical analysis of supply and demand does answer that challenge. Investors, however, can avoid using technical analysis until they realize that those that use both fundamental analysis and technical analysis have the winning edge in beating the Standard & Poors (S&P) 500 Index. As the past 10 years have proved, investing your money in an index fund has yielded little, while many famous blue-chip stocks continue to outperform the index. Technical analysis makes it easy to stay in these outperformers to beat the index.

Technical analysis enables you to identify stocks that are beating the index on a long-term trend basis. Professional portfolio managers have a tough time beating the index because the game is structured against them and they don't know how to use technical analysis. The individual investor has no such problem and can easily find individual stocks that will trounce the index funds. In fact, the professional portfolio managers identify these fundamentally sound stocks for you every day in *Investor's Business Daily*. The portfolio managers are the only ones you need to follow and copy on fundamentals as a small investor. Portfolio managers have the best research available. However, you need to use technical analysis to "cherry pick" the portfolio manager's list to identify stocks with good charts that

are outperforming the market. Forget all the rest of the portfolio managers' good fundamental picks. You only want those that are outperforming the index.

Every portfolio manager, every trader, and every stockholder needs to know the secrets I have taught to portfolio managers over the years. These are not really "secrets" because most technicians will already know them. But to the vast majority of small investors and fundamental portfolio managers, these secrets of technical analysis are not well known. And even if they are known, the users have trouble understanding and using the tools of technical analysis because they are in denial about how Wall Street works and what forces drive the prices up and down on the charts. There are so many technical signals it is difficult to focus on the few that will really help you.

Many investors are blind with prejudice when it comes to accepting, understanding, and using technical analysis to make profits in the stock market. Some have "chart phobia." This book is for them. It is all about using technical analysis, without learning the mathematical details that make up the design of technical signals. We will leave it to the expert technicians to continue their search for the "holy grail" in technical analysis that is the search for the signal that is better than all the others. You are interested only in using the existing technical signals in the public domain that help to make money and improve investment performance. If we could find a black box, proprietary computer program that provided the best technical signal, we would pay for it and use that.

Some profitable, technical analysis signals are proprietary and will never be revealed or, if they are made available, you will have to pay for them. Not all technical analysis signals are in the public domain. Some proprietary signals are available from brokers' sell-side analysts and from independent, third-party research services. Other technicians provide newsletters to the small investor. Publications such as *Investor's Business Daily* and *Value Line* provide both fundamental and technical ratings at a very reasonable price. William O'Neil, the publisher of *Investor's Business Daily*, provides a proprietary service to portfolio managers, emphasizing mostly fundamental, quantitative data on charts that cost tens of thousands of dollars.

Every trader and investor needs to be aware that institutions always have the advantage because they are paying millions for proprietary, legal, research information not available to the public. However, that does not mean the small investor cannot beat the pros. On the contrary, as Peter Lynch often pointed out, the small investor can move more quickly than the big institution and beat them every time. And the small investor only needs 10 stocks to diversify in order to reduce risk, while the portfolio

manager needs 30 to over 100 depending on his style and risk management. It is much easier to pick 10 good stocks than 30 or 100. The small investor can easily beat the pro in the stock market, not because he is smarter, but because he is quicker and has a much easier challenge than the one that faces the professional portfolio manager who has trouble beating the index or the benchmark.

I have found in the articles I have written on MarketWatch.com's Trading Deck and SeekingAlpha.com that many investors have difficulty integrating technical and fundamental analysis. Since I have no such problem, my readers always appreciate the ease with which this is accomplished. It enables them to say "thanks" in their comments, and it reveals the great need for an insightful presentation into the art of using technical analysis in order to make easy profits by both trading and investing. Technical analysis is certainly far easier to learn and use than fundamental analysis. No MBA degree in accounting, such as the one I have, is needed, and that makes it perfect for the small investor or trader, especially the novice.

For the professional traders and portfolio managers, technical analysis is a must. Even if portfolio managers maintain publicly that they make investments based on fundamentals and valuation, they will look at price action. Some are "closet technicians." They will raise questions with their analysts and traders when price movements defy fundamental analysis. This happens frequently.

Meanwhile, technical analysts and traders won't be too interested in the "why" because they will just hit the buy or sell button on their computer, while the portfolio manager or fundamental investor is still trying to find out why Enron is going down and if the fundamental story is still intact. When Enron crashed and burned, many fundamentalists were still wondering why and had enormous losses, but those who used a technical analysis were out, after it dropped from over $90 to $70. They had a technical analysis sell discipline that ignored the fraudulent fundamentals. Since fraud was involved in Enron, the failure of fundamental analysis was excused, but the losses in the portfolio and performance record of the portfolio manager remained. Technical analysis caught the fraud early, as the "smart money" bailed out of Enron and triggered technical sell signals. Those fundamentalists who did not pay Wall Street the enormous research costs for the "first call" and ignored technical analysis were left holding the bag as Enron crashed.

This book will help you make money in the stock market to beat the index, and to completely understand and measure the forces that drive the prices of stocks. Fundamental analysis is only one of those forces. Technical analysis measures all the factors driving price, even the ones that are secret or known only by the professionals and insiders. Technical analysis

provides a level playing field for the small investor. It is the slingshot that allows the small investor to do battle with the giants.

Using technical analysis as an overlay to fundamental analysis provides the winning edge in long-term investing. Technical analysis keeps you in a portfolio of outperforming stocks, sharpens your buy discipline, and puts your sell discipline on automatic. These are the keys to improving portfolio performance by using technical analysis as step one and fundamentals as step two in picking stocks.

One last suggestion, as you come across terms you are not familiar with, please go to this book's companion website (see the "About the Companion Website" page at the back of this book for the URL and password), where we have attempted to provide a full and simplified explanation of the terms used in this book. A more detailed mathematical explanation can be found on StockCharts.com.

Acknowledgments

If my mother, Kathleen Healy, had not given me a prospectus to read at age 12 and asked me my opinion, I would never have written this book.

My daughter, Patricia Zagara, wanted this book and nurtured it chapter by chapter. My sons Rob and John provided the professional critical review. My son Tom Jr. needed the book for his son Thomas K. Lloyd III to challenge him, as I was challenged at an early age. My wife, Eileen, read and made changes on every page. Without all of their help, I would never have completed the work.

The prime mover of this book was Jeffrey Krames, and I am grateful that he started me on the journey. Writing the manuscript is easy but producing the book is the real challenge; the team at Wiley made this a book, not the author. Thanks to my editors, Evan Burton and especially Jen MacDonald, for toiling over the work of a new book author. Everyone knows how important the cover is, and the credit goes to Tula Batanchiev. With 112 exhibits, this is more a graphic art book than a writer's book, and our readers will appreciate their great efforts because a good picture is worth more than all the words.

Without the charts from Yahoo.com and StockCharts.com there would be no easy source for the reader to go to, and we thank them for their generosity. I greatly appreciate MarketWatch.com for publishing my articles and allowing me to reprint them in our case studies. Special thanks to Craig Tolliver and Jason Meyer, my editors at MarketWatch.com. I would like to thank all those who gave us permission to use their work.

I stand on the shoulders of all the great technicians who developed the signals we use in the book. Their discoveries and hard work are taken for granted as we use their gifts every day. Perhaps this book will encourage others to see all the signals that are not yet named or given a mathematical expression.

Finally, a note of thanks to Lee Gundel and the Massapequa Library. They provide my quiet place to write and the venue for my discussion of investing or trading using my approach in this book. In addition, I would like to thank the Plainview Library and all the members of the Long Island Stock Traders group meeting there that helped shape this book, especially Jim De Franco, Alan Gordon, and Tom McNeece.

Successful Stock Signals for Traders and Portfolio Managers: Integrating Technical Analysis with Fundamentals to Improve Performance, Thomas K. Lloyd, Sr.

CHAPTER 1

Using Moving Averages and Relative Strength Performance to Beat the Index

Relative Strength Index, Money Flow Index, Keltner Channels, and Standard Deviation, with Apple Exhibits

KNOW THE PLAYING FIELD

There are fundamental and technical ways to make money in the stock market. The fundamental techniques require education—an MBA or CFA would help—and long hours of research about the financial data of a stock and prospects for future growth. Further, since Wall Street, sell-side analysts are highly paid to do this, you are competing with professionals, while you may be only an amateur fundamental analyst. It is possible, but not probable, that you will be a better stock picker than the professional analysts. Professional fundamental analysis is widely available and free, so use it instead of doing it yourself. Value Line is free at your local library. Online brokers supply such reports as the Standard & Poor's analyst reports free of charge, and most brokers supply a reputable fundamental service or their own fundamental, so called sell-side analysts.

The second way is technical analysis. It can be learned quickly, just by reading this book, and used to make money in the markets. Looking

at charts first, and then reading what the fundamental analysts have to say, is an easy way to make profits in the stock market. Doing fundamental research and then looking at the charts is the hard way. I could never understand why some portfolio managers insisted on doing it the hard way. The system is rigged against them because the first call they receive is from a highly paid, sell-side fundamental analyst with his recommendation to buy a stock. The caller hooks right into the portfolio manager's fundamental bias. The first step in their stock selection process is wrong. The portfolio manager should be looking at charts first, and then he should call the analyst for the fundamentals. This book suggests that you not make the same mistake as the portfolio manager.

Many chart readers, using technical analysis, don't care what the fundamental analysts are saying because they are interested only in price movements and making money based on those price movements. Most *known* information from the analysts and everyone else, including illegal inside information, is already in the price of a stock. That does not mean the price is right or fairly valued. For example, misinformation leads to incorrect pricing. A false rumor circulated about a takeover will take price up. That price will be wrong because important misinformation is creating demand and taking price up. Technical analysis will correctly measure that demand and will be wrong when the truth comes out and price reverses back to where it was.

When you see a comment in print or hear it on TV, it is usually too late to act on because it is already in the market price short term, but it is still valuable information to use for your long-term investing. You wait until the price pulls back from its current, frothy high created by the media blitz and then you buy on weakness like the pros. Traders do just the reverse, riding the momentum created by the media.

Of course, there are always breaking news stories that the market knew nothing about, are not in the price, and immediately affect the price as the announcement is made. This is why all the Wall Street traders (but not portfolio managers) are glued to the news feed looking for positive and negative surprises or rumors.

Wall Street is a whisper business, and all the valuable information is passed over lunch, on the golf course, or whispered on the phone in coded words. It is not given to reporters or put on TV, because valuable research needs a customer willing to pay. It is not given away free in the press or on CNBC, Fox, or Bloomberg. What is given away free is "hype," when the longs or shorts want to get the investing public to move the price on a position they have already taken. It may be good information, but the small investor hears it last from the media when price is frothy and it is about to pull back. The only time there is a level playing field for the small investor is when there is breaking news and it catches the pros completely by surprise.

Then the small investor and the pro have the same information at the same time. This is also true for the small trader versus the professional trader. Stay tuned to CNBC, Fox, and Bloomberg for the news that nobody knew.

David Einhorn, a famous hedge fund manager, exposed Green Mountain Coffee when he went public with his thesis on why the stock was a poor investment. Even if you were the last to hear this research from Einhorn, you made money on Green Mountain as it went down. Sometimes it pays to listen to the TV news or attend conferences to hear speakers like Einhorn. (We will look at Green Mountain Coffee in Chapter 8.)

APPLE COMPUTER'S 200-DAY MOVING AVERAGE

The first and easiest way to make money in the stock market is to buy a company whose products are really "cool" and whose products you are using yourself. Peter Lynch was a proponent of this approach for the small investor. Such companies are making plenty of money and growing with new products. Apple is a good example. It is also possible that a company is making popular products that you are using and the company is losing money on every sale they make. You don't want this company! So always check the chart first and then the fundamental analysts to avoid these momentum chart traps. Just because the chart is good does not mean it has good fundamentals and is a solid, real company. Penny stock scams show stocks with good charts and companies with no fundamental reason for existing.

Notice in Exhibit 1.1 that the initial, long-term buy signal for Apple in 2009 is when price moved above the 200-day moving average. This technical analysis signal is widely used by most long-term investors. It is the solid trend line moving up under price on Exhibit 1.1. That long-term uptrend is still in place. Portfolio managers dream of stock moves like this one, where price moves from $100 to $600 in less than four years. Is it any wonder that almost every portfolio manager has Apple in his or her portfolio? The small investor has a better chance of quickly buying this stock at its low and selling it at its high, unlike the portfolio manager with millions of shares to buy.

Also notice that every time the sellers showed up in red, taking price down on the chart, they were quickly stopped, not even able to move price down to the 200-day moving average. The first real test by the sellers taking price down to test the 200-day line did not happen until the middle of 2011. Price still failed to violate the 200-day, long-term uptrend. Every test by the sellers that fails to break below the 200-day long-term uptrend is a confirmation signal that the positive uptrend will continue. It is a signal to buy on weakness for long-term investors. This is the first and most important technical analysis signal for investors.

EXHIBIT 1.1 AAPL, May 31, 2012, 5-Year Chart
Source: Yahoo.com.

We did know that Apple was a great company led by Steve Jobs and they were coming out with fabulous products. Fundamentally, analysts liked the stock and it was "*G*rowth *A*t a *R*easonable *P*rice." (GARP stocks usually have a good PEG [PE/G], which is a favorable price-earnings ratio (PE), compared to the 5-year growth rate [G].)

Technically, the chart showed that price was going up. So you buy it, using the 200-day uptrend signal at the end of 2009. When price stops going up, you sell it, using the 200-day signal when price breaks below the 200-day as it did twice in 2008. That is the easiest way to make money in the stock market and beat the index. As the 200-day trend started up in 2009, both the fundamental analysis and the technical analysis were completely "in sync." When you have both going for a stock, it is hard to lose money, except in a market crash or a negative surprise, as discussed later in the Herbalife and Green Mountain chapters (Chapters 4 and 8). (Note that the overall market crash even took Apple down below the 200-day in 2008. When it broke above the 200-day, it was a golden opportunity for the long-term investor to "buy cheap.")

20-, 50-, AND 200-DAY MOVING AVERAGES

We can show you the basic signals of the 20-, 50-, and 200-day moving averages with any stock. But Apple is a very exciting story and is

in almost every investor's portfolio. In Exhibit 1.1, we show the 200-day moving average for Apple and its long and uninterrupted uptrend since the bottom in 2009. Likewise, in Exhibit 1.2, we show the 20-, 50-, and 200-day exponential moving averages (EMAs) for Apple. EMAs weight recent data more heavily, whereas the simple moving average weights each day equally.

The line well below price, near the volume bars shown at the bottom of Exhibit 1.2, is in an uptrend starting at the left, bottom corner of the chart. It is the long-term 200-day moving average used by most portfolio managers as a key technical indicator of long-term trend. The upper line, moving up just below price on the chart, starting in January 2012, is the 20-day moving average. You can see that it quickly changes when price changes direction. It follows the short-term trend of price. Traders and hedge fund managers watch this short-term indicator.

Between the 20-day line at the top and the 200-day at the bottom part of the chart, you will see another line, which is the 50-day moving average. This is an intermediate trend line. When it drops down to the 200-day, portfolio managers become worried, as supply takes price lower and threatens the bullish uptrend shown by the 200-day.

As indicators of supply and demand, these moving averages provide a very visual picture and clear buy and sell signals that identify supply and demand. From January to April 2012 in Exhibit 1.2, you can see demand as all three moving averages are in an uptrend. Apple is a short-term, intermediate-term, and long-term buy, according to these signals. Demand is in control and taking price up.

The first sign of trouble is when price breaks below the 20-day the week of April 9, a signal that this price move up is over short term and

EXHIBIT 1.2 AAPL, July 6, 2012, Daily Chart
Source: StockCharts.com.

price has topped out at $644. Now supply is in control and taking price down short term. The 20-day uptrend turns to a downtrend, confirming that Apple is now in a short-term selling cycle. Then price breaks below the 50-day and now you go from a short-term selling cycle to a more worrisome intermediate selling cycle. Another bearish signal of supply occurs when the 20-day breaks below the 50-day. You can see that this happens in Exhibit 1.2 before price bottoms at $522 during the week of May 7.

Finally, there are some signs of demand as price bounces up from $522 but on light volume, indicating light demand. The 50-day line is no longer in an uptrend but going sideways to down. Another good sign of demand is when the 20-day breaks back above the 50-day during the week of June 25. Price is now also above the 50-day, yet another sign of demand. At last at the beginning of July, the 20-day turns up and the 50-day turns up. The selling cycle is over and demand is taking price up.

Although this was a 19 percent selloff from $644 to $522, the 50-day never turned into a downtrend and the 200-day uptrend was never even threatened. For the portfolio manager and small investor this was a "buy on weakness" signal given by the moving averages. Moving averages are very valuable technical analysis signals and the first and easiest to learn and use.

RELATIVE STRENGTH VERSUS THE S&P 500 INDEX

Relative strength performance versus the Standard & Poors (S&P) 500 Index is the key to analyzing any large-cap (capitalization) stock, and is revealing when viewed in Exhibit 1.3. In this chapter, we will exploit the easiest and most powerful examples of technical analysis signals that tracked the demand that took Apple price up so dramatically. Relative strength is simply the comparison of a stock's price movement to the price movement of the index. This is a simple, straight forward arithmetic ratio. It is then plotted and shown in Exhibit 1.3 as "AAPL: $SPX." Notice the uptrend in the line created when the stock price is doing better than the index. As long as this line is in an uptrend, it classifies the stock as one that is outperforming the index. The trend line is calculated as a 20-week EMA. If you want to outperform the index this is the signal to watch.

There is no magic in these signals. Demand takes price up, and these signals measure that demand. It goes without saying that you must check the fundamentals of any stock you trade or invest. Portfolio managers do that "due diligence" for you, and you can rely on their published stock

EXHIBIT 1.3 AAPL, July 6, 2012, Weekly
Source: StockCharts.com.

picks. They may not be good stock picks for performance, but they do have good fundamentals. The chart will tell you whether they are outperforming stock picks. Some stocks will be "special situations," for example, takeover candidates, and the charts won't help. Use Bloomberg, CNBC, *Barron's*, the *Wall Street Journal*, and *Investor's Business Daily* as sources for takeovers. Relative strength and the moving averages will help you beat the index and keep you rotating into winners and out of losers. These are important technical signals identifying demand, which takes price up, and supply, which takes price down.

KELTNER CHANNELS

A quick glance at Exhibit 1.1 and you will notice that the latest move up in price started in January 2012. It came to a peak that was a much larger move than the previous peaks. You can see this more clearly in Exhibit 1.3 by introducing channels around the prices on the chart. The break above the channel at the beginning of 2012 was very bullish and signaling the surprise, and the beginning of a strong move up to a new high. Strong demand is seen not only in this breakout of price above the upper channel line, but also in the spikes of volume to the upside as it does this.

Our other signals in Exhibit 1.3, which we will explain later in this chapter, show price peaking and becoming overbought at the $644 top followed by the expected drop in price when these signals become overbought as they move to the upper limits of the signal. Thus, the pullback in price for Apple was not a surprise. When price bottomed, it was another opportunity to buy Apple on weakness, because the up channel around price on the chart remained so positive even after the pullback from $644 to $522. The formula is: Uptrend Keltner channel + bottom in price = buy on weakness.

MEAN REVERSION

When price becomes overbought and overextended, it usually reverts back down to the mean or average of the price move up. In the middle of the upper and lower bands of the Keltner channels in Exhibit 1.3 is such a mean calculated as a 20-day EMA, the dotted line. The EMA gives a heavier weighting to recent data than the simple moving average method. Notice how price comes off the $644 peak of the move up and returns to that mean dotted line at $522. It is still on the uptrend shown by the dotted line. Price then continues to follow that dotted line uptrend without breaking below it. Despite the bearish pullback of price to the mean, it is still very bullish for Apple because it does not violate the dotted line uptrend and price resumes its uptrend. This is another signal to "buy on weakness."

Exhibit 1.3 shows the price of Apple as far back as March 2010. Notice the Keltner channels the computer has calculated and placed around the prices. You can see there is a nice fit on the price movements. The chart service automatically does this for you, and all you have to do is indicate that you want to use these Keltner channels on your chart. The basic chart service is free at StockCharts.com. They also explain all the signals in their "chart school" section. The mathematics of these signals is readily

available at StockCharts.com, on the Internet, and in many other books, and will not be duplicated here.

BREAKOUT SIGNAL

Notice the breakout above the upper channel line in February 2012 along with the increasing volume identifying very strong demand taking price much higher. *This is an enormous buy signal.*

The channels assist your eyes to see the very positive change taking place in price, thus identifying strong demand. When you see this signal, it is too late to buy Apple on weakness as price goes ballistic. However, traders will play the upward momentum with delight, and some investors will be tempted to chase price.

APPLE'S TOP AT $644

The next question is: When will this very unusual move up end and why will it end? To help answer this question you look at the three signals that appear above price in Exhibit 1.3. Each of these will identify how overbought the price is becoming, and each will signal the inevitable pullback that must always come when a stock price gets ahead of itself. Portfolio managers have to sell this stock, not because of poor fundamentals, and not because it is overvalued, but because they simply have too much of Apple relative to their total portfolio.

They will sell Apple because they have to manage their risk, and at the new lofty prices, they have too much dollar exposure to Apple compared to the rest of their portfolio. Each portfolio manager has a target for the amount of Apple he wants in his portfolio (e.g., 3 percent of the total value of the portfolio). When price goes up rapidly, he has to sell some of his Apple, even though he loves the stock and it is undervalued. Thus, supply is not created by the fundamentals, which are very attractive, but by the rules of risk management that force portfolio managers to sell winners because they have too much of it in their portfolio as a result of the price going up dramatically.

This is frequently and incorrectly identified as *profit taking.* It is not profit taking but risk management selling. The lower prices that result from this type of selling are a gift to small investors, enabling them to buy on weakness because they don't have any risk management problem, especially if they are first-time buyers of Apple. None of the more than 35 analysts following Apple are recommending a sell.

RELATIVE STRENGTH INDEX (RSI)

You can see that all of the indicators shown at the top of the Apple weekly price chart in Exhibit 1.3 are topping out at $644 and turning down. The relative strength index (RSI) is an overbought/oversold oscillator signal completely different than relative strength versus the S&P 500 Index, which is a performance signal. RSI oscillates or moves up and down between a 0 and 100 scale on the chart. Above the 70 line it is overbought, and below 30 it is oversold. On the chart in Exhibit 1.3 you can see RSI is well above the 70 mark almost to 90 when price tops out at $644. RSI is a favorite signal for traders whose strategy is short selling stocks that are overbought and buying (i.e., going long ones that are oversold). Short selling involves borrowing stock from your broker and selling it. You buy it back after the price drops, booking the profit between the buy and sell price. After buying the stock, you return it to the broker you borrowed it from.

MONEY FLOW INDEX (MFI)

The money flow index (MFI) identifies Apple as being overbought and vulnerable to a pullback with a shaded signal above the line in February 2012, well before the peak in price at $644 in April 2012. As you can see in Exhibit 1.3, above 80 on the scale is overbought and below 20 is oversold. The MFI in Exhibit 1.3 goes well above 80 to the 90s, an extreme overbought reading, as price peaked at $644. Thus, this signal is very useful to the portfolio manager who wanted to sell Apple into price strength before price topped out and started its trip down from $644 to $522.

The MFI is like the RSI but includes volume as well as price. It is also known as *volume-weighted RSI*. Since portfolio managers like to sell into strength, this is where they start selling when these two signals are overbought. They don't wait for these two indicators to break down because by then it is too late. Portfolio managers are selling in size (millions of shares) and have to sell well before price actually tops out and turns down as indicated by these signals. In fact, it is the early selling by the portfolio managers that turns these indicators down. Then the traders join in to make money as price falls and their short selling helps to take price down even more.

This short selling exaggerates the real supply and forces price into an oversold position where it becomes a bargain. It is at these bargain prices that short sellers buy to cover their short and return the borrowed stock to their broker. To a certain extent, short sellers create their own profits by driving price down, which is one of the reasons short sellers are hated. This is not real supply, but it has the same results as real supply. Short sellers are

the masters of the self-fulfilling prophecy. They force price down because they think it should go down. Short sellers are not popular with portfolio managers or investors, but they should be because they drive prices down to bargain basement levels when it comes to stocks like Apple. Everyone loves a bargain. The price always bounces back up to where it belongs once the shorts have made their profits and are gone. The market is not efficient but it tries to be.

Traders and hedge funds make money when the price of a stock goes down by selling borrowed stock at a high price and buying it back at a low price so they can return the borrowed shares to their broker. They pocket the profit of selling high and buying back low. Normally, you buy low and sell high to make money. Short sellers do just the reverse and sell high first and then buy low to make a profit. Stock borrowed from their broker enables them to do that.

STANDARD DEVIATION (STDDEV)

In Exhibit 1.3, StdDev is emphasizing the abnormal and enormous move to the upside—just in case you are "chart blind" and don't see it in the price—just by looking at the price chart and the Keltner channel. This signal measures volatility in price and shows enormous moves like this when price makes big, volatile moves. It is calculated based on the average price or mean and the closing price. It just amplifies and confirms what you are seeing on the chart in price movements. For those who can't see it just by looking at the price moves, this signal makes it explicit that something unusual is happening in price movements. Just compare the big move up to all the moves that came before it in Exhibit 1.3 and you will see how significant this is.

RELATIVE STRENGTH PERFORMANCE, AAPL: $SPX

Finally, the relative strength (AAPL: $SPX) signal in Exhibit 1.3 shows a dramatic change in the slope of the upward trend for this performance line. If the stock price is doing better than the index, then the plotted line moves up. This indicates that price has become a strong outperformer versus the S&P 500 Index. It means demand has become very strong for this stock. This is the type of stock you want to own to do better than the index. That is why the demand is so strong because every professional has to exceed the index (benchmark) over the long term or lose his or her job. Therefore, they buy stocks with a positive trend in relative strength and sell stocks

with a long-term negative trend in this indicator and the 200-day moving average.

The trend line in relative strength is calculated on the chart using a 20-week EMA. Violation of the trend line is an important signal of change in price trends. Portfolio managers are forced to sell stocks that continue to underperform the market, just as they are forced to sell stocks that have a downtrend in the 200-day moving average. There is no secret as to why stocks continue to sell off; it takes a long time for a firm like Fidelity to sell off an enormous position in a stock like Apple. Small portfolio managers have it much easier, and the small investor has it the easiest of all.

SUPPLY AND DEMAND

Forced selling by portfolio managers creates the downward spiral in the price of a stock. Portfolio managers are the creators of supply and demand in any stock. Traders, hedge funds, and computer programs will try to front run the selling by portfolio managers, sometimes creating flash crashes, as in the case of Herbalife, Green Mountain Coffee, and Facebook. We will discuss these stocks in detail in later chapters.

As the price of Apple pulls back from $644 to $522, analysts are talking about 12-month high-end targets of $800 to $1,000. The fundamentals are great and not the reason for any pullback. The reasons for the pullback may be many, but they are not fundamental reasons. They are purely technical. That is why technical analysis is so important to the small investor. The small investor can wait, while those portfolio managers who are forced to sell Apple at these overextended prices bring price down and the traders join in the selling to make it worse. The small investor can wait for the pullback to test the 50-day moving average and possibly the 200-day in order to buy on weakness at bargain low prices. Stocks, like anything else, can always be bought at a discount to the recently high prices, a discipline every small investor must learn and every pro already knows and practices.

Again, just by looking at price and volume you can see demand and supply in action. In this case, look at volume increasing as price moves up to overbought at $644 in Exhibit 1.3. This is caused by demand. Then look at volume spiking again as price drops from $644 to $522. This is caused by supply. If portfolio managers had decided to exit Apple in a big way, you would see enormous volume spikes continuing. Someday in the future this will happen—be ready for it. But, as you can see, volume drops off at $522 and price starts to bounce up on light volume. Apple is saved this time around.

What you are seeing is a lack of continuing, high volume supply. Price is dropping not because of strong, continuous supply but rather selling caused by some portfolio managers forced to sell because they have too much Apple. As soon as the traders catch on to this type of selling, they jump right in to sell. Just as quickly as the traders see technical signals reversing, they will reverse and start buying. There may be some slightly bad news having nothing to do with fundamentals. The traders are taking advantage and front running the selling that is taking place. If you are a day trader, you can join in with them.

But if you are a small investor, then understand that the traders and the portfolio managers are giving you a gift by driving price down. You wait until they are finished. You wait for the buy signals and you buy at a nice discount to the $644 high. You buy at $530 or higher at $557 as the bounce starts after the pullback in price is finished. Even if you wait until $557 to buy, you will still be doing much better than buying at the $644 top. Now that the sellers are done, and price is moving up, the next step is to retest that $644 high. See the technical analysis buy signals such as performance relative strength and the 200-day uptrend confirmed by the 50-day uptrend on Exhibit 1.3 that point to a retest of $644.

What you have seen in the Apple chart is a very strong uptrend stock, with enormous demand taking price up to $644. Then an overbought top, identified by the signals we show at the top of Exhibit 1.3, namely RSI, StdDev, and MFI. When these signals break to the downside, you know that the demand that created the top is exhausted and supply is taking price down for the short term.

SUMMARY

In this chapter, the first thing to be learned is the basic lesson of technical analysis: how, by just looking at changes in volume and price, you can visually see demand taking price up and supply taking price down. Technical analysis signals help those who cannot "see" this demand-and-supply action by just looking at volume and price. The old time "tape readers" did this in their head without the benefit of computer signals or technical analysis signals. Some of today's day traders still do the same. High-fequency trading "algoes" (algorithms or computer programs) are blind and brainless, but have cloned and automated the tape readers of old.

The signals of the 20-, 50-, and 200-day moving averages show you when demand and supply are coming into the market based on price alone. As price drops below the 20-, 50-, and 200-day, like dominoes falling, price goes from a short-term sell to an intermediate-term sell to a long-term sell.

The same is true on the way up as price breaks above these moving averages spelling out demand.

The RSI and MFI signals introduce the concept of overbought and oversold and are used by traders to buy on weakness and sell into strength. The MFI uses both volume and price. Performance relative strength is the most important signal for portfolio managers and investors because it enables them to rotate out of poor performers with excellent fundamentals (value traps) into outperforming stocks with good fundamentals in order to beat the index. Like the 200-day trend, it is an important, long-term buy and sell signal. Keltner channels help you to see price trend and important breakouts or breakdowns in price identifying very unusual, strong demand or supply.

Successful Stock Signals for Traders and Portfolio Managers: Integrating Technical Analysis with Fundamentals to Improve Performance, Thomas K. Lloyd, Sr.

CHAPTER 2

On-Balance Volume, Accumulation/ Distribution, Chaikin Money Flow, Pivot Point, Resistance and Support, and Point & Figure Chart, with Apple and Google Exhibits

Even great stocks such as Apple and Google have their bad times, when the price sells off and it is time to sell and wait for another day. In this chapter we are going to discuss the signals that first identify the transition from demand that is taking price up, to supply that is taking price down. On-balance volume, accumulation/distribution, and Chaikin Money Flow are the easiest signals to learn. It is very easy to see the direct

relationship of supply and demand to these signals. They will show demand dropping and supply taking over, thus taking price down. This will happen before the slow-moving 50- and 200-day signals start dropping. They will give you the early warning that change is on the horizon. Leading indicators are the most sought after signals in the technician's tool kit. Reliable ones are very difficult to find. If you discover one, you can make millions on Wall Street.

PRICE AND VOLUME

The first thing you want to do when you look at any chart is to look at price and volume to see demand (i.e., increasing volume with price going up) and supply (i.e., increasing volume with price going down). It could be just strong price moves up or down without volume confirming. Once you understand this simple, visual picture of supply and demand shown on the chart, you will know what to look for in any technical signals that employ either simple or complicated techniques such as third or fourth derivatives.

If you are grounded in the visual picture of supply and demand using volume and price, you will never make a mistake with any other technical signal you use. You will be able to recognize false technical signals that do not correspond to the visual display of supply and demand showing on the chart. You must always see supply and demand in terms of volume and price. Many times you will not have a clear picture of supply and demand because the market does not know where to go next and is not giving any signal. When that happens, you must presume the existing trend is correct until you receive a signal in terms of price and volume to the contrary. Our two case studies of Apple and Google in this chapter will clarify this.

Now looking at only price and volume in Exhibit 2.1, you can see supply spelled out as Apple's price drops from the new high of $644 in April 2012 to the low of $522 in May. Notice how volume increases as price initially comes down dramatically, identifying supply in the market during the weeks of April 9 and 16. But suppose you have chart phobia and can't see this as easily as some others who have high visual IQs. You may have a high numeric IQ and can see changes only in columns of numbers. No problem. You have three signals that are going to help you see this supply that is obvious on the chart to most technicians.

EXHIBIT 2.1 AAPL, July 6, 2012, Daily
Source: StockCharts.com.

CHAIKIN MONEY FLOW (CMF)

The first signal is at the top of Exhibit 2.1 and is labeled CMF for Chaikin Money Flow, named after its author. (Marc Chaikin has a service available using his indicators for both technical and fundamentals. See www.chaikinanalytics.com.) Basically, CMF classifies volume as demand or supply, based on where the price closed relative to the high/low on the day, week, or whatever period you use. If price closes nearer the high for the day, then a higher percentage of the total volume (money flow) is positive or demand. The cumulative total line formed by this calculation is called accumulation/distribution. The average of the last 20 days or periods is plotted to produce the CMF chart line, and it oscillates or moves above and below a horizontal zero line. Below the line is supply, and above the line is demand, as measured by this money flow calculation.

On the week of April 9, the CMF drops dramatically. Notice that the CMF turns below the line on April 16, and as price goes down, it goes deeper below the horizontal axis line. Finally, the line below the horizontal turns up when the worst of the selling is over and breaks above the horizontal axis the week of June 11 at $570, identifying positive demand. You can see that price is improving as that line moves up and above the axis zero line. The CMF line moves up nicely above the axis when demand is in full swing, taking price up easily.

The CMF is just an easy way to show what some can see just by looking at price and volume. The CMF has problems when there are gaps in price on the daily chart, but that can be easily overcome by switching to a weekly chart. Just be aware that daily gaps are problematic on the daily chart, and CMF may not move as much as it should when price gaps up or down on the open.

MOVING AVERAGE CONVERGENCE/DIVERGENCE (MACD)

The next indicator, just below the CMF in Exhibit 2.1, is the very popular MACD ("mac-dee"), which is a very visual histogram. Basically, it saves you the trouble of going cross-eyed looking at two moving averages on the chart and combining them to plot another moving average. I use it to identify buying and selling cycles. This may be a pragmatic interpretation of MACD, but it serves me well in viewing demand and supply forces in action. You can see the nice correlation with price selling off and then transitioning to price going up after bottoming. When the bars of the MACD are below the line, a selling cycle, price is going down. Likewise, when the bars are above the line, a buying cycle, price is going up. Divergences are important. For

example, if price goes up during a selling cycle, that is strong demand; if price goes down during a buying cycle, that is strong supply.

The MACD title in Exhibit 2.1 is followed by the notation 12,26,9 to identify the calculation. The MACD line is formed by the 12-day exponential moving average (EMA) minus the 26-day EMA. The signal line is the 9-day EMA of the MACD line. The histogram you see in Exhibit 2.1 is the difference between the MACD and signal line.

VALUE-ADDED SIGNALS

Notice, as price comes off the bottom at $525 in Exhibit 2.1, there is not the volume supporting price on the way up, compared to the volume on the way down, which, along with price, identified enormous supply. The weak move up is indecisive until price finally breaks above $585 to the upside. The CMF and the MACD were correctly showing more demand strength than could be seen just by looking at volume and price. In this case, the signals provided "value added" to identifying demand, barely discernible in volume and price. This demand was enough to finally break above $585 and move to $614.

USING MOVING AVERAGES

Looking at price movement in Exhibit 2.1 again, you can see some other signals that supported the breakout to the upside. The 20-day moving average fails to break significantly below the 50-day moving average, a positive sign. Also, important to the long-term investor, notice that while the 50-day moving average changed from an uptrend to a sideways trend, it never turned to a downtrend or made any attempt to drop down and test the long-term 200-day strong uptrend. These are very strong signals of continued demand and a lack of supply to take price down. These are signals to "buy on weakness."

Since the moving averages are based solely on price, you have price without volume telling you what demand is saying. In fact, price movement alone is important in identifying supply and demand. For example, insider buying will move price on very low volume. Volume is very useful in confirming price moves, and many times volume leads price. Even though you lacked any significant volume signal as price moved up from the $525 bottom, you could rely solely on price and price-generated signals such as moving averages, to identify the demand that would cause the breakout above $585 and the run up above $600.

PIVOT POINT, SUPPORT AND RESISTANCE POINTS

Anyone who looks at any price chart quickly notices that prices move up and then stop at some level, or they go down and then stop at some level. If you look across the chart, it seems these same levels recur. You can then draw lines across the chart identifying these resistance levels where the price move up is stopped, or support levels where the price move down is stopped.

For those who have trouble seeing and drawing support and resistance lines based on just looking at price in Exhibit 2.1, there is an old rule of thumb calculation used by floor brokers and now automated called *pivot point.* It will identify R1 and R2 (resistance 1 and resistance 2) above the pivot point on Exhibit 2.1 and support 1 and support 2 below the pivot point, labeled S1 and S2. Once price broke above the pivot point, P on the chart, you had a positive signal for the eventual breakout to the upside to test R1 and possibly R2. If you follow the "Jul" line in Exhibit 2.1, you will see P, R1, R2, S1, and S2 on the right side among the candlesticks.

Personally, I prefer to use the Point & Figure (see Exhibit 2.4) to determine support and resistance. I also like to draw the support and resistance lines that are obvious on the chart, where price is stopped on the move up or down. But for those who like a computerized method, the pivot point calculates support and resistance guidelines. The manual methods determine more accurate levels of support and resistance. Breaking above resistance levels is always a bullish signal; breaking below supports is always bearish. There are no support levels on the way down when price drops sharply looking for a new bottom.

REVERSE HEAD-AND-SHOULDERS BOTTOM

It is important to note the positive, bottoming signal formed by the reverse or inverted head-and-shoulders pattern in price. This is not a well-formed head and shoulder but it will do. The head is formed when price drops to $522 near May 21. On either side of the head you look for the "shoulders." The left shoulder, as you look at the chart, is to the left of the $522 head, forms a resistance line or shoulder at around $570 to $580. As price moves up from the $522 low or "head," it is going to hit that resistance on the right side of the head, forming the right shoulder. If price breaks above that resistance, you usually are "off to the races" for a move to the upside.

As you look at this right shoulder you can see the struggle in price action as the right shoulder is formed. It tries to break above $580 to $585. Finally, on July 2, it breaks to the upside and continues up, breaking above

$600. This is the importance of the head-and-shoulders pattern, in this case inverted and bullish because you are dealing with a downside test or bottom (it also appears at tops when the top is being tested and the head is right side up, a bearish signal). Once price broke the right shoulder to the upside, you had a positive signal that the up move would continue. The intermediate-term target of this up move could be a test of the old high at $644.

Traders are very familiar with this well-known, classical pattern in technical analysis. Again, this could be a self-fulfilling prophecy triggered by traders who believe in this positive signal. With the breakout to the upside on the right shoulder, on July 2 the traders were looking for price to go higher and probably would trade in that direction. These are the same traders who were selling it on the way down! They follow the direction of price to make money whether it is up or down.

Investors could care less about the inverted head and shoulders. They are watching the strong uptrend in the 200-day moving average and are now convinced that the 200-day won't even be tested by the selling cycle this time around. With the big sellers gone, after taking price down from $644 to $522, the normal, on-balance buying would slowly take price back up to retest the high.

APPLE EARNINGS REPORT

The 50-day moving average was violated, but now price was back above it and moving slowly higher. There were no big spikes in volume. The traders were now afraid to short it and were joining in on the buying that was taking price higher. Price was now waiting for the next big Apple news, whether it be a negative or positive surprise in second-quarter earnings (actually it is the third fiscal quarter for Apple) or a new product announcement or delay. Any big move in the general market up or down would influence supply and demand in Apple stock. Whatever the news, you would see it create demand and supply on the chart and would see it move price accordingly.

It was highly unlikely that the great fundamentals would change dramatically for Apple. At this point the long-term fundamentals had little to do with the day to day changes in price. Earnings were due July 24, 2012, and the anticipation of those announcements would be creating supply and demand for the short term. As of July 10, with price breaking above $600 again, it was obviously demand. Price was continuing its move up from the $522 bottom that was created by the anomalous selling versus the excellent fundamentals.

CASE STUDY QUESTIONS ON APPLE

Now we will give you a little test, a case problem on Apple so to speak. It is July 24 and Apple will announce its third fiscal quarter earnings after the close at 4 P.M. Your assignment is to determine what supply and demand are saying in Exhibit 2.1 before the earnings announcement. You are not trying to predict what will happen to price after the earnings announcement; you only want to be prepared and proactive for what will happen. You want to know if demand and supply were right or wrong before the announcement. First, you will read an article that summarizes the fundamental view before earnings. Then you will analyze the chart. Finally, we will show you what happened after earnings. In conclusion, we will summarize what the strategy is after earnings for both the trader and the investor. The article, "Apple May See iPhone 'Speed Bump,'" by Dan Gallagher, was published on MarketWatch.com on July 21, 2012, before Apple's earnings, and can be accessed through a link on our website, www.wiley.com/go/stocksignals.

PLANNING FOR APPLE'S EARNINGS REPORT

The planning premise here is that all these comments in the MarketWatch.com article are already reflected in the price. Thus, if these comments miss the mark and earnings are worse than expected by these comments, the price of Apple will drop. However, if Apple does better than the expectations of these comments, price will go up. If there are no surprises, price will keep going sideways as indicated by the 50-day moving average. Usually, the market is inefficient after earnings, so if price goes down, it will probably be oversold and a trading buy. If price goes up, it will reach overbought and become a trading sell.

For bargain hunting investors, if price goes down, there will be buying on weakness. Institutions love to buy on weakness and sell into strength. You saw some of that institutional selling when price topped out at $644 and the market gave back half of the move up from $400 to $640 or $120 as the traders and shorts detected the institutional selling and started front running the continued selling thus exacerbating the move down. Price dropped back down to $522. Once the traders see that the selling is over and done, they will switch to buying because they know the excellent fundamentals as well as anyone. They know the buyers will return to take Apple up. They know an oversold stock when they see one! But they will wait to see demand on the chart before they risk their money.

In Exhibit 2.2, you will see how price is creeping up on low volume, targeting a retest of the $644 high. It never made it before earnings. After

EXHIBIT 2.2 AAPL, July 24, 2012, Weekly
Source: StockCharts.com.

a major run-up and pullback such as you have in Apple, the next leg up should target a new high because the 200- and 50-day moving averages are still in uptrends. Price is still outperforming the market, and this trend in performance is up.

In Exhibit 2.2, notice the long-term buy signal provided by the price of Apple compared to the index (AAPL: $SPX, the last indicator at the bottom of the chart). This means Apple is a long-term buy because it is outperforming the S&P 500 Index. If this signal does not break to the downside after earnings, then Apple will be bought on any weakness by investors. The uptrend in this indicator means Apple is outperforming the index. Investors want to buy such outperformers, and that is why this signal is the most important one on the chart for investors. Extreme value players called *bottom fishers* will buy stocks when this signal is bottoming and extremely negative. This is a tricky game for only the best professional fundamental analysts. On-balance volume (OBV) is the other positive signal, and it has not turned down yet. As you can see, it is going sideways and is vulnerable to a downturn. A continued uptrend would be better.

The negative signals in Exhibit 2.2 are short-term signals starting with CMF at the top of the chart, which has just turned negative. It fell below the horizontal axis, indicating some selling going into the earnings report. No surprise considering the comments you read from the MarketWatch.com article.

The next signal, second from the top, is the MACD histogram. On this weekly chart it is telling you that Apple is still trying to move up from this very short-term sell cycle before earnings. The MACD is showing the tail end of a selling cycle as the bars improve. Both of these signals are identifying very short-term supply before earnings. Below the prices plotted in Exhibit 2.2 you have two other negative signals. Accumulation/distribution, which drives the CMF signal, has dropped and has not turned up yet. The money flow index (MFI), which sometimes leads CMF, has dropped and is pausing, with a possibility that it is ready to turn up.

Overall, the chart is a picture of supply. It will take a positive surprise in a quarter that is not usually strong for Apple to take price up. If there is a positive surprise, any short sellers before earnings will have to quickly cover by buying, driving the price up more rapidly.

If price had made a new high before earnings and if there were a negative surprise, then price would drop sharply. As it is, because of the selling before earnings, the drop will be somewhat muted. Buyers came in at $525 after the last sharp selloff. Even if the earnings are not good as expected, Apple will still be bought at this level. It is highly unlikely that after earnings Apple would go from a long-term buy to a long-term sell. Therefore,

on any pullback, expect the bargain hunter buyers to come in, and expect support levels to hold.

YOU MUST NOW MAKE A DECISION ON APPLE BEFORE EARNINGS

Based on the fundamental background article from MarketWatch.com and the chart signals, it is decision time before earnings. Some traders will think they know the answer and bet accordingly. But most traders and investors will wait for the earnings. Thus, the decision to be made before earnings is: What is your strategy if the earnings are good or if they are bad? Will you buy on weakness if they are bad? Will you chase price up if they are good? If they are neutral, will you wait for a pullback or a breakout?

As with the Harvard case studies, we are not looking for a correct prediction of Apple earnings. More important is your correct analysis of what the analysts are saying and what the chart signals are telling you. Before you look at the answer, take some time to map out your strategy and tactics after earnings are announced.

ANSWERS TO THE CASE STUDY QUESTIONS

When earnings did come out, they disappointed as expected and by more than expected. Price dropped and you can see that in the 5-day (Exhibit 2.3). Our negative indicators on the weekly (Exhibit 2.2) before earnings were correct. The sellers before earnings were right and showed up on the chart with CMF turning negative by dropping below the horizontal axis.

In Exhibit 2.3 you can see what happened after earnings. Apple did better than their conservative forecast. But the consensus of analysts expected Apple to do much better than the company forecast. Because Apple failed to meet consensus by a wide margin, price dropped after earnings were announced. You can see that price gaps down in Exhibit 2.3. Price tests the bottom for a couple of days and then turns up to completely fill the gap-down.

Part of this surprise demand was caused by a rumor that the iPhone 5 would be announced early. Notice in Exhibit 2.3 that a buy signal for traders occurs on July 27 as price moves above the 200-minute moving average, stays above it, and the 200-minute trend turns up. This is confirmed by positive MACD and stochastic signals below the chart. The MACD moves above the horizontal axis and stays above it for the rest of the day. Day traders

EXHIBIT 2.3 AAPL, July 24 to July 30, 2012, 5-Day
Source: Yahoo.com.

trade minute to minute not using these trend signals. But they know "the trend is your friend" and the 50- and 200-minute moving averages tell them about trends. Day traders are trading minute-to-minute shifts in demand or supply. They are watching volume, price, and the candlesticks minute by minute.

After seeing this drop in earnings, I wrote the following article, which was published on MarketWatch.com's Traders Deck, on July 25, 2012, titled "Will Apple Retest $525?":

> *Apple will probably retest $525 on the next, bear market pullback. For the present, it is intent on testing $570 and possibly $555 as shown on the point-and-figure chart. You can see $570 was tested twice and $555 held on four tests to the downside (see columns of Os).*

In another life, I was a corporate insider preparing the quarterly earnings reports for a diversified $5 billion corporation. I learned how difficult it is to predict earnings when you are rolling up the results of 20 or so divisions. In fact, if it wasn't for the law of large numbers, I would say it is sometimes impossible to predict earnings, even as an insider. What chance do the sell-side analysts have when they don't have access to inside information? That lets the analysts off the hook for missing earnings by a wide margin, but what about Apple management?

I think the analysts have not yet adjusted to the management shuffle at Apple. Steve Jobs was a talented CEO who loved to game the Wall Street analysts and win. My guess is that the current management team is more interested in the operational challenges of pushing new product out of the pipeline down the road. Perhaps they are not interested in the short-term game as much as the long-term. They certainly knew the top line well in advance of earnings, and could have guided analysts lower. (Some analysts did downgrade estimates just before earnings.)

I think they need to do a little work on their communications skills with the large number of analysts following Apple. There is no excuse for a surprise of this magnitude for a stock like Apple. (Of course Apple management will point to their lower estimate, which the analysts thought was too low and chose to ignore. They learned this trick under Jobs and it no longer applies.)

In this case, it doesn't really matter. Everyone is focused on the future pipeline and there are many excuses for Apple to miss earnings as customers stop buying the old products to wait for the new. Competition is increasing. Of course, there is the slowdown in the global economy, which will take the broad market down and Apple with it to a certain extent. Not too many institutions are going to run out and sell Apple today because of this miss, much to the dismay of the shorts. So how low will Apple go before the bargain hunters start buying? How low will this negative surprise in earnings take price down? How low will the index funds selling Apple take it down on the next general market bear move?

Understand that the answers have nothing to do with fundamentals. Apple is in the unique position of being a value play and a growth play, which is an oxymoron. On our valuation grid of 8,000 stocks, Apple scores 1.1, or the highest possible score, therefore hardly any fundamental reason to sell it even with this miserable earnings report and the next one which will probably be much of the same.

But look at what happened last December as Apple started its run at $400 and ended it at $644. We can probably expect the same after they roll out their new products expected before December of this year. After all, the mean 12-month analyst target is $750, and that is conservative compared to the highest estimates over $1000. If this December, Apple starts its run at $525 and runs up to $750, that's an implied return of 43%. I think most of the big holders will sit tight until December. Meanwhile the bargain hunters are salivating over lower prices now.

Nobody is going to look at fundamentals to figure out where price is going short-term. That is the job of technical analysis, because everyone already knows the fundamentals. Even as the analysts drop their estimates because of this quarter and next, it will hardly put a dent in valuing Apple for the longer term. However, there will be no more talk of $1000 targets, probably until December.

The chart has support at $555 and $525. If we have a meltdown in October for the market, Apple may even trade cheaper than $525. Instead of putting in a double bottom at $525, we may see a lower-low as it retests the strong uptrend in the 200-day moving average below $525. With Apple, the 200-day test happens infrequently and usually holds.

Exhibit 2.4 is the Point & Figure chart I use to determine support and resistance levels. To simplify the reading of this chart, just look at where the columns of X's and O's end. The top of the X column identifies resistance and the bottom of the O columns identifies support. If price starts dropping then the previous resistance levels identified by the top of the previous X columns, now become support levels on the way down. The exception is the most recent column, which is still a "work in progress." Notice that the most recent column of X's is targeting a test of $615 resistance, which is the price at the top of the last column of X's. This move up is based on a rumor that the iPhone 5 will be announced in September.

As you read these pages, you will be able to update what happened to Apple and see whether it reached its conservative $750 target or its very optimistic $1,000 target. In the unlikely event that the market has crashed, Apple will have broken its 200-day uptrend just as it did in 2008, because index fund liquidations will take down all stocks in the index regardless of fundamentals. Bargain-hunting fundamentalists just love this irrational selling of perfectly good stocks by the index funds. Technical analysis tracks the level of the irrationality and accurately measures the level of supply that is taking price down. It then identifies the bottom and the resumption of buying that will take price back up.

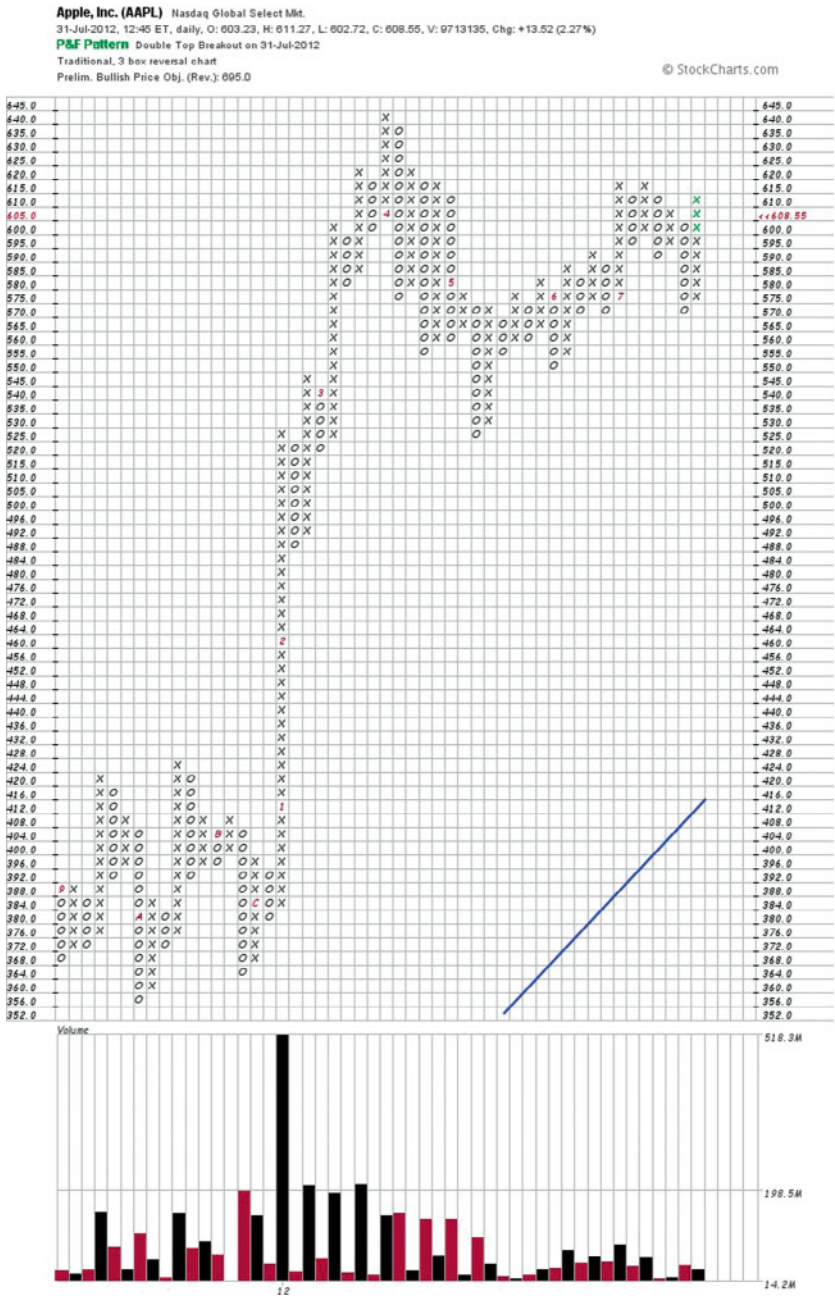

EXHIBIT 2.4 AAPL, July 31, 2012, Point & Figure Chart
Source: StockCharts.com.

SUMMARY OF THE APPLE CASE STUDY

In this case study, you were introduced to some technical signals that help you to see supply and demand moving price up or down. The CMF, OBV, and accumulation/distribution are indicators that enhance what you see in volume and price on the chart. For the investor, there are the weekly charts and the all-important relative strength performance of a stock versus the S&P 500 as well as the 200-day moving average long-term trend signal.

For the trader, there are the intraday charts using 50- and 200-minute moving averages as well as all the other signals such as RSI on a minute-by-minute basis. Many will use signals like the CMF, the MACD, and the Point & Figure chart to identify support and resistance levels.

There is no "hocus pocus" in these signals that are based on enormous amounts of real data about price and volume movements that spell out supply and demand, which are the drivers of price. These technical signals, the measurements of supply and demand are rarely wrong. The market may be wrong because of lies, misinformation, manipulation, and poor investment decisions, but not the technical signals that accurately measure what these factors are doing to price. Technical signals are the best indicators of wrongdoing in the marketplace and will identify any large scale trading on inside information. I tracked many of Ivan Boesky's moves on the charts, but I did not know it was Ivan with inside information. Technicians can always identify such demand on the charts without knowing the cause until much later.

GOOGLE CASE STUDY

Although the Google metrics did not look compelling on its initial public offering (IPO) day in 2004, the market price quickly, and correctly, valued its long-term growth, unlike the Facebook fiasco. Technical analysis was flashing buy signals as price climbed, signals indicated by both volume and the 200-day moving average shown on Exhibit 2.5 in 2004.

In Exhibit 2.5, buy signals are given by the enormous spikes in volume supporting the price move up in 2005 and continued in the beginning of 2006. Notice the solid uptrend line under price, the 200-day moving average. This long-term trend is up, and that is what portfolio managers are looking for in a stock. Every time the sellers appear (dotted red line above price) to test the 200-day, the long-term uptrend holds and is not violated. These pullbacks are a perfect time to buy on weakness. That is what every portfolio manager is trained to do.

EXHIBIT 2.5 GOOG, May 31, 2012, Eight-Year
Source: Yahoo.com.

You don't have to be too smart to get into stocks that have a sharp uptrend in the 200-day. Anybody can beat the index with stocks like these. In Google's case, you are buying it between $100 and $200 in 2005, and the trend takes you all the way up to $700 before falling in 2008, breaking the 200-day uptrend. A blow-off top (an extreme move to the upside in late 2007), warns technicians it may be time to get out and return at a lower price. The break below the 200-day at the beginning of 2008 on Exhibit 2.5 confirms it is time to get out. Here, you have a recurring pattern that confirms sell signals. After violating the 200-day, price bounces back up in an attempt to return above the 200-day. It fails and thus confirms the existing sell signal warning investors to reduce their positions in Google because lower prices are coming.

Traders, using technical analysis, would have sold closer to the $700 top. Portfolio managers would usually exit, when the 200-day long-term trend is broken, provided the fundamental story is broken or market conditions are bad. If mutual fund portfolio managers have to raise cash to meet redemptions because small investors are getting out of the market during a market crash, then portfolio managers will sell their big winners like Google and won't wait for the 200-day signal. In effect, they will create the sell signal, not for fundamental reasons but for the need to raise cash to meet redemptions because small investors who own the mutual fund are fleeing the stock market in panic.

This is just another example of why fundamentals do not determine price in a bear market or a market crash. Technical analysis must be used in this case. Strict fundamentalists will be washed away by a bear market. This might not be for long. As you can see in Exhibit 2.5, the Google crash from $550 to $300 in 2008 is corrected in 2009 as price bounces back up to $600. As soon as faith was restored to the markets, fundamental valuation took over and created the demand for the bounce back up. Bottom-fishing fundamentalists who caught the bottom doubled their money. Technicians who waited for the positive 200-day signal were in around $400 in 2009 for the move to $600.

Exhibit 2.5 shows the profile of a winner that you should be looking for in any stock for the years 2005, 2006, and 2007. The strong uptrend in the 200-day identifies Google as a winner, with strong volume demand for the stock driving prices higher. The sellers, in the red dotted line above price, confirm it is a winner because the pullbacks in price, caused by short-term supply, fail to take price below the 200-day significantly. Note that the years 2009 to 2012 are what you normally see in a good stock with several breaks below the 200-day line, but nothing like the growth and continuous uptrend in the early years.

Looking at Exhibit 2.5 for the years 2009 to 2012 you see a bumpy ride as price consistently drops below the 200-day moving average and reverses the signal to move back above the 200-day. This is a very real problem for both the fundamentalist and the technician. The fundamentalist may argue that despite exceptions, most of the time fundamentals will identify good stocks even when price drops below the 200-day moving average.

Since most portfolio managers know about the 200-day moving average, they will do a check of all their fundamental sources to make sure they are not missing something. They will talk to their analysts and trading desk (technicians!) and come to the conclusion that the fundamentals are still good and they will continue to hold. Or they will decide something is wrong and sell. The technical signals will pick up their decisions, and it will show on the chart. Eventually, the violation of the 200-day will either be a false alarm, as in the case of Google, or it will turn into a full-blown sell signal.

The technician will not necessarily sell on the first violation of the 200-day. He will wait for the bounce back up to test the 200-day, and if it does not get back above it and stay there, the technician will sell. He will check the news and fundamentals to see if he can identify the reason for the sell signal, but, regardless, he will sell if the price fails to get back above the 200-day and continues above it. If it makes no attempt to go back up to the 200-day but instead turns down again, he will certainly sell.

This spells out the basic differences between the approach of the fundamentalists and the technicians. In the case of Google, the

fundamentalists were right in holding on. The technicians had higher transaction costs moving in and out of Google every time it violated the 200-day. The technicians will remember Enron and all the other stocks that kept going down after a confirmed violation of the 200-day. The fundamentalists will remember Google and all the times they were right in holding on despite price dropping. Sometimes technicians will be convinced by fundamentals; sometimes the fundamentalists will use technical signals. Technicals and fundamentals can work together to improve performance.

At the beginning of 2012 Google started underperforming the market. At the end of the second quarter, just before earnings announcements, Google had significantly underperformed the S&P 500 Index, which is the benchmark for most large-cap portfolio managers. As you can see from Exhibit 2.6, on the day earnings were due to be announced, price had broken below the 200-day moving average, and the "death cross" was in place because the 50-day moving average broke below the 200-day. Every portfolio manager knows these two technical signals. Combined with the pain in performance felt year-to-date by the portfolio managers, it was decision time, and second-quarter earnings would help them make the final decision.

The purely fundamental portfolio managers, despite their knowledge of these technical signals, would wait until after earnings to act. Those portfolio managers using both technical and fundamentals as part of the sell discipline were probably already selling before earnings because price had dropped during the second quarter. Disappointing earnings would play into the existing, 50-day downtrend, taking price down to test $560 support (price was at $575). A positive surprise would take price up to test resistance at $610. I wrote an article to this effect published on MarketWatch .com's Trading Deck on July 19, 2012, before earnings came out. Thus, I am not using 20/20 hindsight. Here is the article titled "Google: Fundamental Buy, Technical Sell?"

> *As we wait for Google (GOOG) earnings, there is an obvious dilemma between the fundamental buy signals and technical sell signals. Our fundamental models have it as a five-star buy (best) as shown on Twitter and Facebook. But the charts at Stockcharts.com show many sell signals. Most notable is that GOOG has underperformed the S&P 500 index since the beginning of the year.*
>
> *How long can portfolio managers stand this performance pain before they start selling? Last quarter, portfolio managers added 15 million shares and decreased their holdings by almost as many according to Nasdaq. Have we reached the tipping point where the next report will show the decreased holdings is the higher number?*

EXHIBIT 2.6 GOOG, August 31, 2012, Daily
Source: StockCharts.com.

Note: In Exhibit 2.6 follow the lines up the chart for July 16 and July 23 to see the dramatic change in signals from sell to buy for relative strength (GOOG: $SPX) and on-balance volume before and after earnings came out on July 19.

The chart tells us there is more selling than buying, and Yahoo .com reports on-balance selling by institutions at 4.4 million shares. Price is in a downtrend and has broken below the 200-day trend. There is the "death cross" on the chart, with the 50-day breaking below the 200-day. The point-and-figure chart clearly shows the lower-high-and-lower-low pattern. The lower-high was recently put in place at 600. The lower-low below 560 has not yet dropped into place. After earnings there probably will be a test of 600 or 560.

To break this negative pattern requires a positive surprise in earnings that will move price to the top of the 560-660 short-term trading range. Without that surprise, price is trending down to test the bottom of the long-term trading range 480-90 on the point-and-figure chart. The next downside support is at 560 and 535 if earnings and company forecasts fail to impress.

Recent analyst opinions are downgrading earnings below the mean analyst earnings for 2012, according to the Nasdaq website. This will make it a little easier for GOOG to beat expectations on earnings. Despite the downgraded earnings, the analysts are overwhelmingly bullish, rating it as a strong buy, with 29 favorable to 3 unfavorable. The mean 12-month target is 750, with the low-high target range of 640-850. Any negative surprise will bring down analyst targets. However, according to Finviz.com, the latest analyst raised the target from 733 to 752, very close to the mean analyst target.

Conclusion: GOOG has much to prove in this earnings announcement to change its under-performer status on the chart and the recent analyst lowering of 2012 earnings targets. The short-term trend is down and it will take some positive surprises to turn that around. On the three-year chart, there is an ascending triangle looking for a breakout to the upside. That needs a positive surprise to happen, but will it happen today? The analysts' 12-month targets are saying "yes," but the chart is saying "no, not yet."

(As always, consult with a professional financial adviser before making any decisions based on this article. Nothing in this article recommends a buy or sell on GOOG stock. Chart signals can be wrong and computer models are subject to error. Analyst targets are educated guesses. You need to do your own due diligence on GOOG.)

This is a good example of fundamental analysts versus technical analysts where the fundamentalists win. The market's view of Google before earnings was wrong. Technical analysis measures that view and when the market participants are wrong in their decisions about Google, technical analysis will appear to be wrong. Technical signals are always 100 percent

correct in measuring what the market is saying about a stock, not just what the fundamentals are saying.

After earnings, Google's price starts a march up from the double-bottom showing in Exhibit 2.6 in June. It not only tests the upper limit at $600, but blasts through it and, as can be seen in Exhibit 2.6, reaches almost $690. The move up shows price first going above the 50-day downtrend, then above the 200-day, and finally the last, lagging buy signal to click on as the 50-day breaks out above the 200-day for the "golden cross."

The market can be wrong and can frequently miss catching the exact bottom. The double bottom was in place, indicating that Google had tested the bottom adequately and it held. This is a sign that it could be ready for a bounce up, but that was only a possibility, not a positive technical signal.

In fact, there were bullish technical signals on the chart despite the overall negative tone. In Exhibit 2.6, the CMF was in the green, showing a strong positive profile despite the fact that price was coming down before earnings. Also, the ascending triangle in Exhibit 2.5 was a long-term bullish signal that you could have a breakout to the upside reversing this intermediate downtrend in price.

Despite these positive technical signals, the overall picture was negative,which is typical of a stock at its bottom. The 50-day downtrend, the death cross of the 50-day below the 200-day, and the long-term underperforming trend in relative strength versus the S&P 500 Index were all compelling supply signals that showed no signs a positive bounce was eminent. Thus, despite some positive technical signals, the weight of evidence seemed to spell supply that would not easily disappear except with an earnings surprise.

The overwhelming majority of fundamental analysts were right in expecting the earnings to be good and that would take price up closer to their 12-month mean target of $750.

With price at $690 after the earnings report, close to that $750 long-term target, you can expect this move up to end very soon and reverse to test the downside support. As of August 31, the date of Exhibit 2.6, the mean analyst 12-month target had not increased from $750, which is surprising and a negative as price approaches the 12-month target. Analysts may start downgrading if they feel it is overvalued at these levels.

In Exhibit 2.6, by following the July 16 line up and down the chart you can see clearly what the signals were saying before earnings. The CMF and its close relative accumulation/distribution are clearly positive and for some time before the earnings are announced (a good leading indicator in this case). The short-term MACD signal has clearly dropped to the horizontal indicating the start of a sell cycle (which never comes!). Relative strength, GOOG: $SPX, is definitely negative, although one could make

a case that it is showing a double bottom. OBV is neutral but looks like a slight uptrend.

Now go up and down the July 23 line and memorize these buy signals that eventually take Google up over 100 points. See the radical move up in relative strength, OBV, accumulation/distribution, MACD, and CMF. These are the technical signals of a positive surprise creating demand and taking price up. Technicians missed the bottom but will be buying these positive signals.

Look at the two big spikes in volume before the 23rd. This is an enormous volume confirmation of the buy signals you are seeing in price. The price buy signals before the 23rd line are astounding. Price gaps up and you can see the space between the candlesticks as price jumps up from the previous close. Price breaks above the 50- and 200-day before the 23rd line. Every time price breaks above a resistance level, it becomes a better stock, a stock with driving demand. Before the July 23 line, Google broke above three major resistance lines: the 50-day moving average line, the $600 price resistance mentioned in my article, and the 200-day line. More important is the startling break above the moving average for relative strength, which is the best signal for an investor. If you weren't buying on the open, Monday, July 26, at $600, then you weren't paying attention to these technical signals. Take a copy of this chart and paste it on your computer screen. This is what you are looking for whether you are an investor or a trader. Buying a stock off its bottom but not on its bottom, and using Google's numerous buy signals off the bottom, is the goal of the investor.

Technical analysis is not too concerned about missing the bottom on Google. Yes, it would be nice to buy at the bottom, but that is very risky. Instead of buying at $570 and risk being wrong, isn't it better to buy at $600 knowing that you have nothing but buy signals so strong the price continues up almost another 100 points? Technical analysis may miss the bottom or the top but it will realize all the profits in between. It may be late buying off the bottom but it won't miss a major move up such as Google.

There is a very important lesson to be learned here for the small investor. Usually when the small investor is wrong, just as the whole market was wrong on Google before earnings, there is a tendency to hate the stock because you were wrong and you had lots of company. If you give in to such emotions, you will fail to see the strong buy signals, and you will miss the opportunity to participate in Google's big move up.

When you are dead wrong as an investor or trader, don't let your emotions rule, and instead immediately switch your position and play the strong buy signals for the very profitable trade to the upside in Google. When the market is dead wrong, as it was in the case of Google before earnings, you have the best opportunity to make money on the very strong

buy signals after earnings. All you have to do is move past your emotions and quickly switch your attitude from seller to buyer of Google based on very substantial reversal of sell signals, to buy signals shown on the chart between July 16 and July 23, 2012.

When you are *wrong big* or the market is wrong big, you have your best opportunity for a profitable trade or as an investor to buy at a nice discount to where price is going from here. Obviously, this is easier for the small investor and trader to do than the professional hedge fund or mutual fund managers who have positions in the millions of shares. Once again, this emphasizes the big advantage the small investor and trader has versus the professionals who can't move as fast or as cheaply as the small guy.

SUMMARY OF THE GOOGLE CASE STUDY

The longer the time frame on the chart, the more accurate will be the technical signals. Looking at the long-term chart on Google, it is relatively easy to stay long during the early growth years, following the uptrend in the 200-day moving average. Every time this uptrend is tested and holds, you can buy on weakness knowing that the pullback only confirmed the long-term uptrend. Recent years show frequent violation of the 200-day with technicians rotating in and out while the fundamentalists hold and ride out the storm.

Looking at a daily chart for Google, using the CMF, accumulation/distribution, OBV, the MACD, and the most important, relative strength versus the S&P 500, you can fine-tune your buying of a stock that is bottoming as each signal turns positive. This sequence of events is stunningly shown in Exhibit 2.6 as it reverses all sell signals in a matter of days. When fundamental and technical signals are in sync, as they were for Google on July 23, 2012, buying becomes a "no-brainer" for both trader and investor.

Successful Stock Signals for Traders and Portfolio Managers: Integrating Technical Analysis with Fundamentals to Improve Performance, Thomas K. Lloyd, Sr.

CHAPTER 3

Bottoms and Tops, Buying and Selling Cycles, and Percentage Price Oscillator (PPO), with IBM and Hewlett-Packard Exhibits

By taking a 50-year look at the IBM and Hewlett-Packard (HPQ) charts, let's examine the typical tops and bottoms that occur on charts over time. Looking over such a long period of time, it is easy to see the buying and selling cycles. Support, where price stops moving down, and resistance levels, where price stops moving up, are much easier to see. You will learn how to identify and use these levels in determining whether demand will continue to take price up or supply will continue to take price down. These long-term charts also answer the question: which is better, a buy and hold strategy or rotation out of underperforming stocks into outperforming stocks when the 200-day moving average is crossed?

INVERTED HEAD-AND-SHOULDERS BOTTOM

Here are the technical signals that were pertinent to IBM (Exhibit 3.1) over time. It has a similar pattern to Exhibit 1.1 in Chapter 1, with price breaking above the 200-day in 2009, and the uptrend continues into 2012. But notice the difference in price performance. Apple goes from $100 to $600, while

IBM goes from $100 to $200. Portfolio managers are happy to own IBM but ecstatic when they find an Apple, which is rare.

This is a good example of the trade-off between good fundamentals and great performance. Portfolio managers with their bias for blue chips might select an IBM over an Apple. Those portfolio managers who have corrected their fundamental bias with technical analysis will look at the performance of Apple and select it over IBM because the Apple fundamentals are good and Apple performance will far exceed IBM's performance.

There is no excuse for the small investor to ever miss a stock like Apple when almost all portfolio managers own it to the limit, usually 3 percent of the total portfolio money. A few portfolio managers will double weight it at 6 percent of the total in the money in their equity fund because they are willing to take more risk.

In the 5-year exhibit of IBM (Exhibit 3.1), we want to show how easy it is to identify tops and bottoms, cycles, and support and resistance levels. If you follow the line identified as "Jan 08," you will discover the inverted head-and-shoulders bottom, which is a bullish signal for a reversal of the existing down move in price. Indeed, price does reverse the negative break below the 200-day moving average and moves up from below $100 to above $120. The head is right on the line, a pointed head down, and the shoulders

EXHIBIT 3.1 IBM, May 31, 2012, 5-Year
Source: Yahoo.com.

are the pointed shoulders found on each side of the inverted head. This is not a well-formed, rounded head-and-shoulders pattern.

DOUBLE TOP AND "V" BOTTOM

Next in the Exhibit 3.1 is an example of the double-top, bearish formation in the summer of 2008. It foreshadows price falling from $130 to $80 and breaking below the 200-day. The enormous drop was caused by the market crash. There is a "V" bottom at the end of 2008 at $80, and that bottom marks the beginning of an enormous move up from the bottom back up to $130 during 2010 and then on to $200 in 2012.

The "V" bottom at the Jan 09 line on the chart is typical of a sharp reversal in supply and demand. At this bottom it is important to note that the crossing of the 200-day to the upside at $100 in 2009 comes too late to be a useful signal. Too much of the move up is lost. The earlier buy signal is when price comes down hard but does not go all the way down to retest the bottom at $80, but puts a higher low in place at about $86, thus confirming that price is already off the bottom and ready to move up. The "V" bottom is bullish because supply has evaporated. The "W" bottom is tricky because supply is still in control and takes price back down to retest the bottom a second time.

RESISTANCE

The chart has already identified resistance at the double top where price failed before at $130 followed by the big drop down to the bottom. That double-top resistance is near $130, formed in the 2008 double top. Price made two attempts to get above $130 and failed, making this an important resistance level for the future. As price marches up from the bottom at $80 at the end of 2008, it gets stopped by this double-top resistance throughout the first half of 2010. In the last quarter of 2010, it finally breaks above this resistance and forms a new uptrend outlined by the 200-day moving average. This was a key test of the 200-day moving average at a very important double-top resistance level at $130 and the breakout to the upside was an enormous bullish signal as price continued up from 2010 to 2012 reaching over $200.

Breaking above a key resistance level is always an important buy signal. Sometimes this breakout is a bull trap; that is, it sucks buyers in with a false buy signal that quickly fails, thus trapping the buyers in a bad trade. To avoid the bull trap, wait for confirmation; that is, price comes down to test the breakout and bounces up from old resistance, confirming it is now

a strong support level or continues straight up, as in the case of IBM in Exhibit 3.1.

CYCLES

In addition to the bottoms and tops shown on this chart, as well as the support levels at the bottom and the resistance levels at the double top, notice the regular cycles. On a regular basis, price comes back down in a recurring selling cycle to test the 200-day, and then starts another buying cycle to retest the last high. From 2010 to 2012 these short-term buying and selling cycles were so predictable and expected, they could be profitably traded. Portfolio managers would use these cyclical pullbacks to add to their position in IBM. They would be buying on weakness for any stock like IBM that was in a strong, long-term 200-day uptrend.

WRITING PUTS AND CALLS

Once you have this 5-year picture in front of you, it becomes easy to use the daily and weekly charts to profit from these cycles of buying and selling. Many investors holding IBM for the long term in their portfolios would make extra money writing (i.e., selling) puts and calls. The price they receive for selling the puts and calls becomes income when the options expire worthless. Their stock has not been "called" away from them, so they have maintained their core position in the stock. In addition, nobody "put" additional stock to them so they did not have to buy any additional IBM stock, although they were ready to do so if IBM reached the low price of the option, called a *strike price.* Only technical analysis and its signals will enable you to do this with discipline so the options expire worthless and you bank the price at which you sold them.

Calls and puts are options to buy or sell a stock at a certain strike price. If you own IBM stock and you want to make some additional income, you can write a call option on your IBM stock. When the stock has one of its regular cyclical pullbacks, it is relatively safe to write a call option, an option to buy IBM stock. You will receive money called a *premium* for writing (selling) the call option. Since the price of IBM is falling during one of its cyclical pullbacks shown on the chart, you expect IBM price to go down, while the buyer of the call option expects the price to go up. If the price goes down, the call option expires worthless and you keep the premium or price you sold the call option for, and thus you make extra income on your IBM holding. The option to buy your IBM stock expires worthless to the buyer of the call you sold, and you keep the price he paid you for the option.

When the selling cycle is over and IBM stock begins to bounce up again, you can sell a put option, which gives the buyer a right to sell you IBM stock at a lower price. If you have the money and don't mind buying more IBM at an even lower price, you will feel comfortable selling someone the right to sell you IBM stock at a lower price. As it is, IBM is in a buying cycle and price is going up. You expect the put, the option to sell IBM at a lower price, to expire worthless, and you keep the price you received for the option you sold. Obviously, nobody in their right mind is going to exercise an option to sell you IBM stock at a price lower than what it is currently trading. The put, the option to sell, is worthless, and you keep the money you received when you sold the put option.

THE "CLOUD STOCKS" FOR THE FUTURE

Long-term, successful companies like IBM are constantly changing their stripes to be successful. IBM evolved from a keypunch card calculator company to a software/computer company, to mainframe company, to PC company (it exited PCs!), to consulting company, and since we are now doing full circle "back to the future," a "cloud" company. I am sure IBM will win. The cloud sounds much like the environment that IBM started in, namely, centralized computing. All you need is a keyboard on a mobile phone or tablet and you have access to the mainframe power in the cloud. It certainly beats the puny computing power of the PC.

LONG-TERM INVESTING

Let's look at the IBM signals to see how you discover companies like this and stay with them for 50 years because they are in an uptrend. Can you play them successfully for the next 50 years? Do you even want to? Exhibit 3.2 shows the long-term view of IBM and HPQ for comparison, going back to 1962.

Surprisingly, HPQ outperformed IBM over the years. But as the end of the chart in Exhibit 3.2 shows, HPQ performance is now headed down while IBM is going up. Thus, going long IBM and short HPQ might provide a stock pairs hedging opportunity for the short term. Theoretically, it is possible to make money as IBM goes up by buying long and short selling HPQ to make money as it goes down. Now you have a hedge just in case the general market takes both down at the same time because you will make money on your short in HPQ to cover the losses on your long in IBM.

EXHIBIT 3.2 IBM versus HPQ, June 11, 2012, 50-Year
Source: Yahoo.com.

HPQ is now going through the painful transition of trying to reinvent itself, evolve, and survive as a growing company. Meanwhile, IBM seems to have evolved successfully, at least for the short term.

BUY-AND-HOLD STRATEGY IS PROBLEMATIC

Portfolio managers dream of finding long-term stocks like IBM and HPQ. But notice the long periods of nonperformance, of sideways movement for IBM in Exhibit 3.2. Surprisingly, in 1992 after 30 years, IBM reaches down for zero cumulative performance for the 30-year period. IBM shows spurts of growth where the slope of the 200-day move average turns up rapidly, then levels off and goes sideways. Also, the downturns in trend are not easily or quickly reversed. It emphasizes the problem with "buy and hold." Obviously, by looking at this chart with 20/20 hindsight, it would have been better to rotate out of IBM and into the better performing stock HPQ.

Technical analysis is the key to such a strategy for improving portfolio performance. Buy and hold stocks that are outperforming the index and sell them when they have an IBM profile versus the HPQ profile shown in Exhibit 3.2. This is the way to pick the best stock in an industry or sector. Portfolio managers need to go with the best-performing stocks in the

industry, not the best fundamentals. Of course, the fundamentals have to be good, but not necessarily the best. Portfolio managers tend to overweight fundamentals and underweight performance, and that is one of the reasons they have difficulty outperforming the market index or their benchmark. That is why they need to use technical analysis to overcome their fundamental bias.

I use a quantitative system that has this same fundamental bias that portfolio managers have. I override its decisions by using technical analysis to overweight performance and underweight fundamentals. This is the secret to outperforming the index. Only prejudice against technical analysis prevents portfolio managers from using this approach. They need to take Exhibit 3.2 and frame it with the caption "Performance versus Fundamentals" or use it as wallpaper on their computer to help overcome their fundamental bias.

Exhibit 3.2 will also remind them that all good things come to an end. As you can see on the chart, HPQ has failed miserably recently after putting in a deadly double top on the 2010 line in Exhibit 3.2 that was below the previous high and thus very bearish. That was the point to rotate out of HPQ and into IBM, which is performing much better on the chart.

Notice on the HPQ 50-year performance (Exhibit 3.3) that we show performance compared to the Standard & Poors (S&P) 500 Index, identifying it as a strong outperformer compared to the index. The top line on this chart is HPQ cumulative performance. The bottom line tracks the

EXHIBIT 3.3 HPQ versus S&P 500, June 12, 2012, 50-Year
Source: Yahoo.com.

performance of the S&P 500. The line closely tracking price at the top of the chart is the 200-day moving average.

This is the way to beat the index and by a large margin over time. However, there are false sell signals as price just temporarily drops below the 200-day only to resume the basic upward trend. The challenge of technical analysis is to avoid these false signals. The way it does that is by waiting for confirmation of the breakdown; when the next move up to go back above the 200-day fails, it confirms that the first sell signal is correct.

In the following case study, you will learn how to use technical signals.

HEWLETT-PACKARD CASE STUDY

In the case study section of the chapter, you are challenged to sit in the chair of the investor or portfolio manager who owns a stock just before the next earnings announcement. The purpose is not so much to guess whether the earnings are going to be positive or negative, but rather to proactively develop strategy and tactics for the stock after earnings are announced. In other words, after you hear the latest earnings, will you buy more or sell your position? Will you chase price to buy if the earnings are good, or will you wait for a pullback to buy on weakness? If the earnings announcements are bad, will you sell as soon as possible or wait for a bounce up in price to sell into strength? (*Hint:* Many portfolio managers will sell immediately after bad news or buy immediately after good news. Acting immediately avoids the angst of selling at a lower price or being forced to buy at a higher price. Portfolio managers are not traders and have no interest in guessing the next, short-term market move in price after the earnings are announced. Wall Street traders know this and legally front run predictable behavior patterns by portfolio managers.)

In the case of Hewlett-Packard, you are waiting for the earnings to be announced after hours (i.e., after trading closes) on August 22, 2012, at 4 P.M. EST for the New York Stock Exchange (NYSE). There is an after-hours market so that it is possible to trade after the market closes. Due to liquidity considerations and to trade efficiently in size (i.e., in very large trades), most institutional investors will wait for the markets to open the next day in order to execute their orders with institutional trading desks that will take a multimillion-share order. It is also possible to trade the liquid markets around the world as Asia and then the European markets open before markets open in the United States.

Hewlett-Packard closes at $19.20 just before the earnings announcement. In early 2010 it had traded as high as $54 but in the past 12 months only as high as $30. Hewlett-Packard was in a downward price spiral and

there was little anticipation that this earnings report would improve the situation. According to Nasdaq.com, only 6 of 24 fundamental brokerage analysts following the stock had "buys" for it. A few analysts upgraded earnings and downgraded earnings before the report; all were near the average analyst earnings forecast of $4.06 for the year. Going into earnings, the analysts were "standing pat" on their already negative view of Hewlett-Packard. Another bad earnings report would not be that much of a negative surprise.

The bigger issue was when to buy an undervalued stock such as Hewlett-Packard, despite the current bad news on earnings. When would the turnaround under the new CEO begin? When would the stock really hit bottom? How low a value would the market put on Hewlett-Packard so as to attract buyers known as bargain hunters or bottom fishers? How much selling would the bad earnings report bring out and how low was low?

Market bottoms in a stock are usually identified by enormous selling in terms of volume and a significant drop in price. The last fundamentalist holdouts throw in the towel and finally sell out their position in Hewlett-Packard. This is called *exhaustion selling*, and once all the sellers are gone, so to speak, there is the basis for the bargain hunters to swoop in and begin the long process of driving prices higher. For this to happen, the expected turnaround would have to be seen on the horizon by investors. First the bargain hunters and then the more hesitant buyers appear. Bottom fishers usually don't know when the price will start back up, but they are willing to wait because they are long-term investors and there is little downside risk to the stock. Those with shorter time horizons, namely, small investors, will wait for the price to start up in a recognizable uptrend before they will buy, unless they are just buying for a 3 percent dividend.

The challenge for you in this case study is to be ready after the earnings come out. Will you buy an undervalued stock with a good dividend and be willing to wait for the turnaround to start? Will you wait for still lower prices and still better value for this undervalued stock? (*Hint:* Some dividend driven mutual funds may have a buy discipline threshold such as 3.5 percent yield and will not buy until the dividend goes over that point created by a lower price on the stock.)

CASE STUDY ANSWER

As expected, the earnings came out and they were not good. The price dropped in the after-hours market from the $19.20 closing price to $18.28. The next morning price opened at $18.05 and closed at $17.64. One analyst downgraded the stock to a "sell" and reduced his 12-month target from $20

to $15. (The average analyst target was $26.) If the $15 target were right, the implication was clear that price would drop below $15 short term. But this was only one analyst's opinion.

As Exhibit 3.4 shows, the price dropped over 8 percent on 3.5 times normal volume—another robust technical sell signal in both price and volume. The rules for determining this as a sell signal depend on the risk you are willing to take. Portfolio managers might not consider this a sell signal; more important than a 1-day signal would be the 200-day moving average signal. Traders and small investors would consider any abnormal change in price and volume a sell signal. Here, you have a sell signal that is well above the abnormal limits, with price dropping 8 percent and volume increasing 3.5 times normal. A good sell signal rule might be anything above 5 percent drop in price or above 3 times normal volume. Traders might have a much lower rule, such as a 3 percent drop in price on double normal volume for their sell signal.

The earnings news created enormous supply, which took price down to test the bottom. It was trading over $20 only two days before. Now the bottom at $17.41 shown in Exhibit 3.4 was in question, and it looked as if a lower low could be put in place if the selling continued into the next day.

Comments from management and the analysts indicated that the turnaround would not happen short term. Therefore, the turnaround buyers

EXHIBIT 3.4 HPQ, August 23, 2012, Daily
Source: StockCharts.com.

would not appear in the short term, and the sellers would continue selling, taking price down looking for a bottom.

If you owned the stock, would you sell to avoid still lower prices? (Obviously, some holders of the stock opted to do this after earnings were announced.) If you did not own the stock, would you buy here or wait for lower prices? If you were a trader, would you sell the stock short, planning to buy it back at $15 for a profit on the short sale? Or would you buy into the selloff for the dead cat bounce up?

PERCENTAGE PRICE OSCILLATOR (PPO)

You will see in Exhibit 3.4 dated August 23, 2012, that the PPO and Chaikin Money Flow (CMF) have turned negative after earnings. The PPO is very similar in calculation to the moving average convergence/divergence (MACD). The numbers shown right after the PPO title in Exhibit 3.4, namely, 12,26,9, refer to the three moving averages being used. The big difference in the PPO is implied in the name. Instead of taking the raw difference between the two moving averages, the PPO takes the difference between the 12- and 26-day moving averages and converts it to a percentage of the 26-day moving average price. Using a percentage has the advantage comparing low-priced stocks and high-priced stocks equally because a percentage change is being used rather than the actual numeric price.

The CMF never showed a strong positive signal when price was moving up to $20 before earnings, a negative signal (negative divergence). With both of these signals negative and a sell signal in terms of volume and price—the basic indicators of supply and demand—it will be very difficult for the previous bottom at $17.41 to hold. Short term there may be a technical bounce up to fill part of the gap-down in price, possibly a 50 percent retracement. The PPO signal on the daily chart is dropping indicating a sell cycle, but price has already dropped so much that even as the sell cycle plays out in the next week or two, price may not drop much more, especially if we have a quick bounce up to fill the gap.

Following is the article I published on MarketWatch.com's Trading Deck on August 23, 2012, titled "Who Is Buying H-P Stock Today?" after the earnings came out:

> *After another disappointing earnings report, Hewlett-Packard, HPQ, dropped almost a point to $18.28 in the after-hours market Wednesday, and the question is who will be buying HPQ on Thursday? The Wall Street institutional trading desks will welcome the sellers with open arms as long as the haircut in price makes it a no-brainer for a little bounce back up.*

This is a value gem (according to StockpickerUSA.com, a 5-star, undervalued buy) and the dividend is approaching 3% as price drops lower. The sell-side trading desks and their sales traders will be flipping this blue-chip name at higher prices to the bargain hunters. Who might they be? The sales traders have a very up-to-date list, but we can peek at an outdated list of institutions that are new buyers of HPQ at Nasdaq.com. We really don't need to have an updated list because we are not selling HPQ to anyone.

The tactics of the Wall Street institutional trading desks will be to buy HPQ as cheap as possible on emotional selling Thursday, hopefully at the last bottom around $17.50. It may take all day, or a few days, to accommodate the sellers. When they are finished, price will start a dead-cat bounce up as bargain hunters start buying. Hopefully, the stock that the institutional trading desks bought for $17.50-18.50 can now be sold at higher prices, possibly a bounce back up to resistance at $22. This would be a nice profit for the trading desks that were willing to risk their firm's money buying when others were panic selling (or simply forced selling of an underperformer).

Why would the sellers even think of selling HPQ, an undervalued stock, at rock bottom prices? They may think it is going lower, or perhaps they just can't take the pain any longer. What pain? It is the HPQ lack-of-performance pain that is killing the overall performance of the portfolio manager. Just follow the link to this chart which shows how long HPQ has underperformed the S&P 500.

HPQ started underperforming the S&P 500 in the early part of 2010, and the downtrend line on the chart shows an unbroken underperformer since that time. How long do you stay with an underperformer until you dump it? What is your sell discipline? If it is a fundamental discipline, you will continue to hold and may even buy more HPQ as price continues to drop. If it is a technical sell discipline, you were out of HPQ when it first started underperforming or when price broke below the 200-day moving average.

In May of 2010, HPQ was around $41. If you used the "death cross" sell signal—when the 50-day moving average crosses below the 200-day — then you would have exited your HPQ position in March of 2011 around $40. Hindsight is 20/20, and technical signals don't always work. As you can see on the HPQ chart, price moved back above the 200-day in a fake-out move to the upside. But there was no such problem with the death-cross sell signal which has not yet reversed itself nor has the 50-day even turned up to threaten a reversal of the sell signal.

As everyone knows, the market looks ahead and prices a stock accordingly. HPQ will bottom and turn up when the market first

perceives a turnaround in the making. Bargain-hunting fundamentalists will say that the stock is very oversold compared to its intrinsic value calculated by a discounted cash-flow model or some other fundamental valuation technique. They will buy at what they perceive to be the fundamental bottom in price.

Technicians, on the other hand, will wait for confirmation that the double or triple bottom is in place (or a saucer bottom.) They will wait for the breakout to the upside and the start of a new move up by the 50-day moving average, then the 200-day moving average, and finally the golden cross of the 50-day above the 200-day. One thing is sure: the fundamental investors will always be too early and the technical analysts will be late as price comes off the bottom.

Fundamentally, HPQ is becoming more undervalued as price drops. Technically, it has not put a confirmed bottom in place and is still putting lower-lows and lower-highs in place, the profile of a down trending, underperforming stock not loved by portfolio managers except those who are looking for a bargain.

MY ANSWER TO THE CASE STUDY

As you can see from my article, my technical analysis answer is that HPQ has not yet bottomed; it will probably go lower looking for a confirmed bottom. Since it is obvious to most value investors that it is too early to start buying, the bottom fishers and bargain hunters are not going to jump in with both feet. Momentum players won't touch it. Without demand being created by both of these sources, there is nothing but supply-on-balance in the market. Such supply takes price lower regardless of the fundamental valuation of HPQ.

The key question left unanswered by the fundamentalists is: what is the price that will attract value and bargain hunting buying? If, as one analyst has indicated, the 12-month target is $15, then obviously the current value of HPQ is below the target, perhaps $13.50. By the time you read this book you will know the bottom, and the chart will tell you when it is time to buy using all the technical signals discussed here.

SUMMARY

The advantage of looking at long-term 50-year and 5-year charts was shown in this chapter. The obvious and glaring signals on the long-term charts must always be in front of the investor and trader if he is to use technical

signals profitably in the daily, weekly, or intraday, minute-by-minute charts. All short-term movements and technical signals must be played out with reference to the long-term charts. These charts teach the important basics of bottoms and tops, support and resistance, and buying and selling cycles. They show the glaring weaknesses of a long-term buy-and-hold strategy as well as the benefits.

The Hewlett-Packard case study gives the reader a chance to play portfolio manager just before earnings are reported. It shows how to overlay the charts and technical analysis signals on top of the fundamentals and what the fundamental brokerage analysts are saying about Hewlett-Packard before and after earnings. Finally, it shows both the trader and investor how to play Hewlett-Packard after the earnings came out.

Successful Stock Signals for Traders and Portfolio Managers: Integrating Technical Analysis with Fundamentals to Improve Performance, Thomas K. Lloyd, Sr.

CHAPTER 4

Sell Signals

Double Top, Failed Momentum, 10- and 20-Day Trends, Broken Support, Aroon Oscillator, and Directional Movement with ADX, with Herbalife Exhibits

TECHNICAL SIGNALS BEFORE A BLOWUP

Negative surprises that take price down dramatically are often preceded by slowing momentum, broken support levels, double tops, and 1-day candlestick sell signals. In this chapter, you look for the early warning signals of trouble ahead, using the Herbalife debacle. It was triggered by questions asked during a company earnings report conference call while the markets were still open. This is a case study of what the market knew and when. The fundamentals had not changed, yet price was cut almost in half by fear of a famous short player's asking questions. Did anyone tip their hand by selling short before the incident and did technical analysis see the signal?

We present the reader with the chart showing the unambiguous signals, buy or sell. Then we analyze what actually happened and why. Sometimes the signals will be wrong, and we want you to learn that technical analysis, just like fundamental analysis, can be wrong. As any trader or hedge fund manager knows, being wrong can be just as profitable as being right, because you quickly reverse your trading decisions, to make up for your losses and probably make some easy profits playing the reverse position.

Portfolio managers, who are long only, are not able to do this, although sometimes they can use options to protect the portfolio. That is why the long-only portfolio manager demands technical signals that do not reverse easily and are completely different than the signals for traders and hedge fund managers. Long-only portfolio managers need reliable, long-term buy and sell signals, such as the simplistic 200-day moving average because it is

very expensive for them to unwind a large, long position. It is also difficult to find another good stock to replace the one you are selling.

Their strategy is to buy undervalued stocks, hold them for the long term, and sell them when they become overvalued or blow up for some unexpected reason. It is very difficult to find good stocks, and when you find them, you like to hold on to them for the long term. That way you can spend most of your time looking for another good stock to add to your portfolio, instead of constantly trading the stocks you have in your portfolio. It takes enormous research costs and time to find new stocks. That is why the small investor must "piggyback" on the portfolio managers doing all that fundamental research work.

As a quick example, one portfolio manager I was following, with $12 billion under management, had a large position, over $100 million of Herbalife. It was trading at $72 before a famous short seller asked some questions on Herbalife's earnings conference call, questioning the quality of the revenue numbers. Obviously, there was no way to positively identify the caller who used the name. Maybe this will change in the future!

TECHNICAL SIGNALS AFTER A BLOWUP

As you can see in Exhibit 4.1, the stock dropped from $70 to $42. No announcement was made by David Einhorn that he had shorted the stock. If that portfolio manager I was tracking, who owned Herbalife (HLF), decided to sell, he was faced with unloading his position at a monstrous discount from the recent high price into a market where few were in the mood to buy.

Herbalife started buying back their stock to support the market price. It is not easy for long-only portfolio managers to move out of stock positions. This is why stocks stay on the bottom for a time, because it takes time to exhaust all the sellers on the bad news as portfolio managers gradually unwind their long position. In this case, there was no bad news, only the fear of a famous short seller's asking questions! The fundamental metrics were still intact if you were just looking at balance sheet and income statement data. If you were just looking at fundamentals, Herbalife was a great bargain after the price was cut almost in half. The big question was how many end-user consumer customers were buying the product versus the "distributors" buying the product?

What was in question was the quality of the revenue stream and whether Herbalife sales were a result of a pyramid marketing scheme that would eventually collapse. Portfolio managers, looking solely at fundamental metrics, had bought hundreds of millions of dollars of this stock.

EXHIBIT 4.1 HLF, June 1, 2012, Daily
Source: StockCharts.com.

Fundamental analysis had failed them. Now the basic business model was being questioned publicly on an earnings conference call by someone who identified himself as David Einhorn, a famous short seller. This was the same short seller whose comments saw Green Mountain Coffee fall from $115 to $20 due to his fundamental analysis.

The market is an emotional animal, reflecting the emotions of the participants where fear and greed are the predominant factors that cause bottoms and tops in the stock market. Technical analysis is neither right nor wrong. It keeps tabs on these emotions and the prices they create in the stock market. Technical analysis is 100 percent correct in measuring the emotional moves of the market, but these moves by the market may be dead wrong. As you will see in this book, this will provide opportunities to make money using technical analysis. You will find out if the move down in Herbalife was one of those wrong moves. Herbalife has had this business model for many years. It has been questioned by portfolio managers and analysts for years and has stood the test of time. Is it a fraudulent business model or an acceptable one such as Avon's?

Value players and bottom fishers using fundamental analysis will spot when the market is wrong in a selloff, will jump in and buy a stock when it

hits bottom. Thus, they use technical analysis as a contrarian indicator. A stock hits bottom when everyone else has sold out their positions and there are no more sellers left. Note that this is just a manner of speaking because every trade involves a buyer and a seller. So there is no such thing as "no more sellers left." To be more accurate, one needs to say that there are no more sellers "on balance" remaining. That is to say, the buyers and sellers are at equilibrium and the price is no longer dropping because of the sellers outnumbering the buyers, forcing price down to find a buyer at a cheaper price.

I wrote about Herbalife in my MarketWatch.com article. It will be presented in this book as a good example of fear, not fundamentals, but technicals, driving the price down. We will follow up on the portfolio manager to see if he sold into the fear or held his position based on the fundamentals. Technically, there is a big sell signal in place on the chart, but there was no such signal before the questioning of the business model on the company conference call. The fundamentals were good, or portfolio managers would not have bought it. Now the question is: are they fraudulent like Enron?

If the shorts had been active in a big way before the conference call incident, the chart would have picked it up. But the chart was making new highs! There was certainly a technical sell signal after the company conference call incident, while the fundamentals that took Herbalife to a new high of $72 remained unchanged. Sometimes nothing works for even the smartest portfolio manager, and that is why these unpredictable blowups make it so difficult to beat the index. The game is to have more winners than losers. Even the best portfolio managers have losers and are blindsided by news like this.

Next, in this chapter, you are going to look at the short-term signals that the traders are using to trade Herbalife. Then you will examine the long-term signals for the portfolio manager who is trying to decide whether to sell at this bottom or buy more.

DOUBLE-TOP WARNING

As you can see in Exhibit 4.1, Herbalife has a double-top formation just before the plunge into the abyss. On March 19 and again on April 23, it touches the top near $72. On April 24, just to make the point this is the top, the stock drops sharply and puts in place a red-body candlestick, the size of which had not been seen on the way up since January 2012. We explain candlesticks in Chapter 5, but for now it is enough to say that the candlestick is red because price went down on the day. The top of the red body is the opening price and the bottom of the red body is the closing price. In addition, the relative strength index (RSI) moves down sharply because

the latest day is weighted equally with the previous 13-day average. Traders would take notice of this reversal and the drop in RSI. Somebody was selling, and it may be the short seller because there was no spike in volume. The RSI and the candlestick revealed April 24 as an unusual selling day compared to the rest of the year. Support at $69 was broken, another bearish signal, but support at $67.5 was tested on April 24 and held.

The classical, double-top bearish signal was now in place, confirmed by the break in support and warning that the run-up could be over and price was ready to turn down. Another break below a support level would again confirm the bearish double top and the continuation of a fall in prices. It tests the top one more time on April 26, followed by a negative reversal day on April 27, shown by another long red candlestick signaling unusual selling. Herbalife is now vulnerable to a selloff based on these signals before the earnings announcement. Someone was selling before earnings and it was not the portfolio managers, who would have spiked volume much higher than that shown. It was probably a short seller.

Earnings announced after the close on Monday, April 30, beat estimates nicely, but the forecast was not that good and the stock price did not pop up after hours. When it opened the next morning, May 1, it opened flat to the previous close near $70. After the open and during the earnings conference call, someone who identified himself as a famous hedge fund manager raised questions about the quality of the revenues and the price plunged, as you can see on the chart, from $70 to $57 in one day; it was as low as $52 on the day. Volume was enormous, at 31 million shares—more than 10 times normal volume. For me, 3 times normal volume is a major sell signal. The next day, May 2, it closed at $53 and the day after at $46. As you can see on the chart, the bottom was at $42. Price had fallen 40 percent even though the fundamental metrics were unchanged, but questions were raised about the alleged pyramid scheme business model and quality of the revenues. Technicals had correctly measured the fear factor, but the fundamental metrics had not because they are not designed to do this. Only technical analysis measures this fear factor. Whether that fear in the market turns out to be correct is another story that you will watch unfold.

Did the double top prior to the earnings announcement predict this kind of drop? Of course not. It merely indicated bearish weakness before earnings. The red candlesticks identified unusual selling, but not in volume before earnings. Light volume selling is typical of insider selling or short selling. Only the unusual move in price tips you off. The company did issue a slightly negative forecast, and this was probably causing the weakness before earnings were announced. Or it might have just been the normal selling of “weak holders” before earnings. It also could have been short selling or selling by those who knew that a person was going to ask questions during the earnings conference call.

Technical analysis is not really interested in the reasons for the selling. It is only interested in recording the selling, measuring it to see if it is meaningful and giving a bearish or bullish signal. In this case, Herbalife was giving bearish signals before earnings. It was identified by the classic sign of a double top before prices fall and by significantly bearish candlesticks and the reversal and drop in the RSI shown in Exhibit 4.1. The chart also shows the moving average convergence/divergence (MACD) and RSI giving sell signals and falling before earnings.

THE 10- AND 20-DAY MOVING AVERAGE SIGNALS

The short-term 10- and 20-day moving averages are quick to tell you when short-term momentum in price is slowing, just as the 50-day shows intermediate-term slowing and the 200-day violation indicates the long-term slowing of price momentum. Each of these indicators also identifies a change in trend: short-term, intermediate-term, or long-term. In the case of Herbalife, both the intermediate-term 50-day and the long-term 200-day were in bullish uptrends. To catch the slowing momentum that formed the double-top sell signal, you have to look at the shorter-term moving averages.

Exhibit 4.2 shows these moving averages and some other signals showing slowing momentum, or a topping out of the strong price move up that took price from $51 to $72 on the chart. In Exhibit 4.2, the 10-day moving average breaks below the 20-day moving average the week of April 2, and gives an early warning of slowing momentum. If there is news pending, such as just before an earnings announcement, this is a signal of supply and you can see price going down. It is just confirming what price is doing. This is just a technical signal to help you move past your emotions in case you do not want to see supply taking price down. This signal makes it explicit, just in case you need a signal to see what is obvious on the price chart namely that price is dropping because of supply.

The most difficult challenge for traders and investors is to have a bag of tricks that remove emotion and prejudice from distorting what you are seeing. Most technical signals are lagging and therefore very actionable. You can procrastinate when there is no signal but you must act when there is a technical signal because the signal has already procrastinated for you. It is already late and must be acted on when the signal appears. The 10- and 20-day moving averages become garbled as you approach the disaster or "D-day," but they are still showing weakness because the 10-day did not decisively break above the 20-day the way it was before the breakdown. There is no longer an uptrend in the 10- and 20-day moving averages because of sellers.

EXHIBIT 4.2 HLF, August 13, 2012, Daily
Source: StockCharts.com.

AROON OSCILLATOR AND DIRECTIONAL MOVEMENT

Just in case that is too subtle to see in Exhibit 4.2, you have the Aroon oscillator above the chart showing a very distinctive turn down that does not correct to the top where it was. Likewise, at the bottom of the chart, the directional movement signals clearly show supply developing before the earnings report. Further, the lines below that solid line show the upper demand line in green dropping below the lower supply line in red before "D-day." The lower supply line in red takes over and jumps to the top as the price of Herbalife fell out of bed on Tuesday, May 1, 2012.

The Aroon oscillator tries to identify trend changes by counting days from the last high and low during the past 25 days. The middle line is a zero line and a break below that indicates a change from an uptrend to a downtrend. Here, we are using it just to signal something that is going on that you may have missed by looking at just prices on the chart. In this case, if you can't see that there is an uptrend change in the 10- and 20-day moving averages or you are not convinced, then the Aroon does this quite decisively by dropping below the zero line, thus warning you. It later "waffles" by coming above the zero line and then dropping back down when price

falls off the cliff. In late June, the 10- and 20-day moving averages turn up, as price starts a dead cat bounce up from the bottom. In July, the Aroon confirms the change in trend to up by moving above the zero midline.

Also at the bottom of Exhibit 4.2 is the directional movement with average directional movement index (ADX). The ADX is the dark solid line. As you can see, it moves up when there is a clearly defined major trend and fades or moves down when the price of the stock is trendless. Traders use different signals for an uptrend/downtrend market than for a sideways trading market. Oscillators identifying overbought and oversold work well in a sideways market, a trading range market.

The thin lines or plus D1 and minus D1 lines are computed by comparing current high/low to previous highs/lows for 14 days. You can see, as price moves up, the plus D1 line is on top and moving up, while the minus D1 is moving down identifying demand on balance. Then the signals reverse and cross over showing supply on balance as price goes down.

Notice what happens before May 1 when earnings are announced. All the lines are converging bearishly. The dark ADX line has dropped because the market is trendless and going sideways. The upper plus D1 line in green was high at the very beginning of the chart, reflecting demand, but now has dropped due to price weakness and is ready to crossover. The minus D1 line on the bottom in red is moving up ready to cross over the plus D1 line, indicating supply. When price falls off the cliff on May 1, minus D1 immediately goes to the top of the directional movement signal chart, signaling extreme supply. Thus, you can see how useful this signal is in identifying changing trends and the change in demand and supply moving price up and down. The black ADX line at the bottom of the chart drops in April, correctly signaling that the uptrend is over. It does the same thing in May, correctly signaling that the major trend is over—in this case, a major downtrend.

COMMENTS AFTER THE HERBALIFE BLOWUP

Here are some excerpts from an article I wrote on MarketWatch.com on May 4, 2012, after the big selloff in Herbalife:

> *The blood is running in the street, Wall Street that is, when it comes to Herbalife and Green Mountain Coffee. That spells big profits for those who know what they are doing and can buy when the sellers are exhausted. Traders are only interested in identifying the short-term bottom and the dead-cat bounce up to resistance to make a profit. (Or piling into the short until price hits bottom.) . . .*
>
> *Herbalife has just come off a new high, and it may take some more time to identify the bottom. This is the first selloff by*

institutions, so it is possible that we have not yet seen the bottom. But like GMCR last Nov., HLF may see a bounce that retraces half of this move down. Thus we could be looking at a bounce up of 10 to 15 points if it follows the GMCR pattern. Resistance appears to be at 49 and 59. The 200-day moving average is also near 59 and price, having broken below the 200-day uptrend for a long-term sell signal, may try to go back up to the 200-day, in an attempt to reverse this negative signal.

Traders could care less whether the HLF business model is flawed, because they are only interested in the support level for a bounce up and the size of the bounce. HLF is trying to establish that support using a buyback of stock, but the support level will be determined by the shorts when they start covering. That will happen when they see value buyers, such as bottom fishers, finally decide that HLF is not another Enron and the value is compelling enough to buy. The only thing HLF has in common with GMCR is the name Einhorn, enough concern to cause a panic in selling.

The metrics show that HLF may not be as easy for the shorts as GMCR. HLF has a nice dividend, a gross margin of 80 percent, more than double GMCR, which means they have a lot more options to cut costs, such as the CEO's enormous remuneration. Price to cash shows that HLF may have half the problem of GMCR. HLF has much more financial muscle than GMCR. The analysts are not downgrading the stock or the profit estimates yet, but this happened late with GMCR. Of course if there is an accounting problem, than the earnings could be in question, but that has yet to come out.

The case against HLF has yet to be proven. It has a long established business model and there was never any secret about its marketing tactics. Is it a seriously flawed model or fraudulent? Is growth seriously slowing because the marketing tactics have flooded the channel and there are no more new distributors to buy product? Has the well run dry? All these questions have yet to be answered and meanwhile the market has to come up with a price for HLF. As every bottom fisher knows, the market will err on the downside when faced with the unknown. Inefficient markets are where the value players make their money, but, of course, they have to be right. And they have to be smarter than Einhorn and the shorts.

Panic is never good for any market or any stock. The regulators, market makers and specialists primary directive is to provide an orderly market. Have we had anything resembling an orderly market in Herbalife and Green Mountain selloffs? Are these stocks Enron's in the making? Obviously, when you have panic selling, you can't expect the market makers and specialists to maintain an orderly market. They simply don't have the resources to hold back a tsunami of selling. . . .

As you can see in Exhibit 4.2, price did indeed have the expected dead cat bounce up from 43 to 55 for a 12-point gain for those traders playing the bounce up off the bottom for a nice 28 percent short-term gain. The technical signals pointed out in Exhibit 4.2 encouraged traders to play the bounce up.

HERBALIFE CASE STUDY CHALLENGE

From the preceding information, you have some of the planning premises necessary to make a decision about Herbalife if you are a portfolio manager. I checked the $12 billion portfolio manager I was tracking, and he decided to sell his Herbalife position based on all the information above. You can be sure he will not reverse himself and go back into Herbalife despite the nice bounce up. Burned once is enough. A CEO who was paid $75 million should have had a better answer prepared for a question that was raised once before about Herbalife.

However, the challenge for the portfolio manager, who did not own Herbalife before, is the same challenge for you in this case study. Namely, would you buy Herbalife at bargain prices? Bernie Madoff proved that a Ponzi scheme can go on for years. Does the fact that Herbalife has a long business history, and its modus operandi has been examined many times, assure us that it is legitimate and not fraudulent? Does the enormous, recent payout to the CEO present an ominous red flag questioning Herbalife management? Are their operations similar to Avon, a long-established and legitimate marketing model? Is the extension of the Herbalife growth into the emerging markets now saturated? Will there be a contraction in Herbalife growth, along with the contraction in the European and Chinese economies?

All of these questions must be answered to the satisfaction of a fundamentalist portfolio manager doing his or her due diligence. After reading everything the fundamental analysts on Wall Street have to say about Herbalife, and then looking at the markets where the company is making its profits and growth, the portfolio manager will make his decision whether to buy. That decision will appear on the charts and technical analysis will identify the buy signals or the lack of buy signals.

You are that portfolio manager, but before spending a large amount of time, money, and resources on investigating Herbalife as an investment, you want to look at a chart first. You are not going into a stock that is underperforming and will hurt your performance. You are not going to park your money in a stock that is still bottoming. You want to see some life in Herbalife, not a dead fish lying on the bottom.

After looking at Exhibit 4.3, take time to formulate your technical analysis and decide whether you are going to do all of the fundamental research

EXHIBIT 4.3 HLF, August 31, 2012, Weekly
Source: StockCharts.com.

necessary as a portfolio manager. Then look at our answer. (*Hint:* The company immediately started buying its stock when it hit bottom, so some of the demand you see on the chart has nothing to do with fundamentals but is caused by the company's trying to support the price of its stock by buying it back on the open market. Such price support is only a temporary fix and may provide the shorts with an opportunity to short at higher prices at the top of the bounce up.)

The basic question to be answered by any portfolio manager looking at this chart is: are there any buy signals indicating the bottoming process is over and HLF is ready to move up? If not, then why commit precious resources to do fundamental research on this stock? Why even take calls from analysts recommending it?

ANSWERS TO THE CASE STUDY QUESTIONS

The first signal for the investor and portfolio manager to check is at the very bottom of the chart. It tells you whether HLF has broken to the upside and gone from underperformer to outperformer. The answer is no, although it looks like a bottom is forming. Investors want outperformers in their portfolio, not stocks such as HLF, which is still underperforming the market on a trend line basis. The trend line is formed by the 20-day exponential moving average (EMA 20 line).

Next, did this latest buying cycle take price above the 200-day moving average (MA 40 line or 40-week line) to correct that sell signal? The answer is no. It tested the 200-day and failed by heading back down.

Has the death cross of the 50-day (MA 10 line or 10-week line) dropping below the 200-day been corrected? No, but at least the 50-day has turned up and is moving in the right direction to correct this sell signal.

Did volume spike up on the bounce up? Yes, but nowhere near the size of the spikes in volume as price fell to the bottom.

Did the CMF improve? No, it is deeply below the line showing no improvement despite the move up in price to test the 200-day downtrend.

Did the MACD show a good buying cycle above the line? On the contrary, despite the bounce up in price, the MACD shows an anemic, almost nonexistent buy cycle to the upside, compared to the intense downside bars below the line during the big selloff.

Did the pivot point show any buy signal? Yes, price broke above the pivot point, P, on the chart at $49 and went as high as $56. This signal did not hold. Price just broke below $49 to $48.39, reversing the buy signal

back to a sell signal. Support (S1) on the chart is at $34. Price support, established by the latest bottom, is at $42 to $44, and that seems to be the short-term target. Price wants to test for a double-bottom possibility at $42 to $44. The failure of the pivot point to hold at $49 is ominous and bearish.

The money flow index (MFI), OBV, and accumulation/distribution turned up nicely. Isn't that good? Yes, they did correlate with the price move up, but did not move high enough, reflecting the failure of price to move above the 200-day line. Now all three signals are following price down and seem to be rolling over. The weakening of these signals indicates a retest of the bottom at $42 to $44. The traders are seeing this and will start selling it short again to realize the potential of a 5- to 6-point gain on the trade by shorting at $48 and covering at $42 to $43.

Conclusion: There are no buy signals in place yet. The bounce up is finished, and the sell signals, particularly at the top of the chart shown by the CMF and the MACD, indicate that a retest of the bottom is imminent. Price broke below the pivot point and the 50-day uptrend, giving more bearish signals. Exhibit 4.4 shows more dramatically the weakness of all signals during the short-term selling cycle.

THE DAILY CHART LOOKS MORE BEARISH

As you can see clearly in Exhibit 4.4, price has broken below the 50-day at $50.41 and is intent on testing price support at $47.50 and $45. It is possible that these supports might hold, but the weight of evidence of all the signals indicates that these support levels will fail. It would be a positive surprise if they held and it did not retest the bottom.

Looking at Exhibit 4.4, you can clearly see that the MACD is very negative, with the bars below the line marking the extent of this sell cycle in the number of days. However, the low volume as price goes down indicates that the exhaustion selling at the bottom removed most of the weak holders of this stock. There is no big selling volume left, only a lack of buyers. Considering our analysis of the chart for the case study, it is obvious that most investors and portfolio managers are not yet willing to step up and buy this stock. They may not even be willing to spend any resources on doing the fundamental analysis of this company. But the Wall Street broker analysts will continue to do their fundamental research on Herbalife so that they can be the first to tell a portfolio manager that it is time to buy.

EXHIBIT 4.4 HLF, August 31, 2012, Daily
Source: StockCharts.com.

SUMMARY

In this chapter, you learned how to see the double-top warning and the negative candlesticks that lent credence to the double top. You used signals you have already learned: RSI, MACD, relative strength, CMF, accumulation/distribution, OBV, 10- and 20-day moving averages, pivot point, resistance/support levels, and money flow index. You also learned new signals: the Aroon oscillator, directional movement with ADX, and trading the dead cat bounce.

In the case study of Herbalife, you saw what appeared to be a perfectly healthy fundamental stock fall off a cliff. These are the type of blowups that are a fundamental portfolio manager's worst nightmare, hurting overall portfolio performance and making it difficult for portfolio managers to beat the index. There were subtle technical analysis hints of selling, such as a double top, and some unusual downside candlesticks on the chart just before the fall, but no blatant sell signals. The fundamental metrics have not changed on this stock. That was not the cause of the fall. Fear of a famous hedge fund manager's selling short was the cause.

Now only changes in technical analysis will make this a buy again, while the fundamental metrics remain the same as they were before it fell to the bottom. The fundamental question about the validity of the business model is being reexamined, but that will not change the existing fundamental metrics that are in place. If the business model passes muster, this stock price will move up to where it was before it went over the cliff. If it turns out to be something like a legal pyramid marketing scheme, it will stay on the bottom. The chart will tell you what the final decision is by the portfolio managers. The chart will show the bottom fishing bargain hunters amassing their positions. Such demand cannot be hidden from technical analysis signals.

Successful Stock Signals for Traders and Portfolio Managers: Integrating Technical Analysis with Fundamentals to Improve Performance, Thomas K. Lloyd, Sr.

CHAPTER 5

Supply and Demand, Candlestick Signals, and Point & Figure Chart, with Facebook Exhibits

CANDLESTICK SELL SIGNAL FOR FACEBOOK

From day one of trading, Facebook (FB) provided an enormous, 1-day sell signal on the candlestick chart, showing extraordinary supply taking price down on monstrous volume. The candlestick in Exhibit 5.4 shows the bearish reversal sell signal with price going higher than the $42 open to the $45 high very briefly and then closing below the open at $38, on enormous volume. Look at Exhibit 5.1 to see what happened minute by minute on the first day of trading.

You know the reasons for this supply, and it has nothing to do with fundamentals but rather errors in pricing the initial public offering (IPO), and flooding the market with additional shares of the stock before it ever opened for trading. The IPO so completely satisfied demand before the open that when it opened there was nothing left but sellers looking for a quick profit. That supply took price down not only on opening day but for months thereafter.

This will become the classic IPO disaster case study at every business school, the *Titanic* of all IPOs that will be studied and talked about for years. It is a classical technical analysis case showing the basic forces of

supply and demand in action rather than fundamentals, although egregious valuation was certainly one of the factors, but not the most important. LinkedIn had the same valuation problem and doubled on the first day of its IPO. Supply and demand was the cause of the Facebook IPO disaster and not fundamental analysis.

The candlestick (see Exhibit 5.4) and Point & Figure (see Exhibit 5.5) charts were immediately available at the close of day 1 to give you technical insight into supply and demand on the daily chart. On the intraday chart, within hours most of the technical signals were available to day traders using minutes as the interval instead of 1-day time periods shown on the daily charts.

It would take weeks before many of these technical signals were up and running on the daily chart. Thus, the daily chart of Facebook is a good tutorial for the student of technical analysis watching these signals fall into place on the chart over time. Since many of the signals are not available, you are forced to learn and use the basics, such as volume and price. The Point & Figure chart is quickly available. The value of knowing candlestick charting is exhibited. On-balance volume (OBV) is another early signal you can use. They all tell you about the supply and demand that is driving Facebook price. Later in the chapter you will see Chaikin Money Flow (CMF) and the money flow index (MFI) oscillator appearing on the charts to help us.

FAILED FACEBOOK VERSUS LUCKY LINKEDIN

Like LinkedIn, Facebook was completely over-valued fundamentally. But LinkedIn more than doubled in price on their IPO date. Why didn't Facebook double? With LinkedIn, demand was king, but with Facebook, supply was king. As a result, LinkedIn soared and Facebook dropped like a fallen angel.

The fact that both were extremely overvalued proved that fundamentals had nothing to do with the path that price plotted for each IPO. Facebook decided to sell an additional 80 million shares the day before the IPO and flooded the market with supply. LinkedIn did the opposite and did not issue enough shares to meet the very strong demand. That is why LinkedIn was a highly successful IPO and Facebook was a "bust." Also, LinkedIn had a working business model that had already monetized its product. Facebook was struggling to monetize mobile, the wave of the future.

Technical analysis is completely accurate in measuring supply and demand, using price and volume. For this reason, the first lesson technicians and traders learn is "never fight the tape" or never fight the electronic chart because that plots the electronic or digital data tape showing price changes

and volume. Following the block trading tape or chart shows you what the professionals are doing.

The Facebook IPO came to market on Friday, May 18, 2012, at $38/share. Because Facebook was so popular, there was great demand for the stock before coming public, and the investment bankers and their client Facebook kept raising the price from $28, until they finally decided on $38. To compound the error of anticipated demand, they issued an enormous 25 percent increase in the supply of the stock going to market. They pushed the IPO beyond the limits of both price and demand, flooding the market with supply. The price failed miserably. It was a great lesson in the power of supply, when demand is completely satiated. A great lesson in technical analysis, namely, that supply and demand move price and these factors can be measured and seen on a chart or by a black box (using secret computer code for high-frequency trading) to process volume and price changes.

PORTFOLIO MANAGERS PREFER FUNDAMENTAL ANALYSIS

Fundamental analysis is great, until there are times when the only thing you can use is technical analysis. That is why traders use it. Frequently, when there is breaking news on a stock, fundamental analysis is ignored and the stock trades, based on supply and demand. A spike in supply and price goes down; a spike in demand and price goes up. It is that simple, and the traders, specialists, and market makers are reacting to the supply and demand. For the trading moment, the fundamentals are irrelevant. Portfolio managers may be able to ignore technical analysis, because they are long-term investors, but every time they are buying or selling stocks, they are the victims of or beneficiaries of technical analysis because that is what their trading desks are using.

I once called a portfolio manager with some excitement in my voice to warn him that one of his biggest holdings could drop 10 points on the news. His reply was, "Tom, I don't care. I am in this stock for the long term. If it drops 10 points, I will probably buy more." On another occasion, I called a portfolio manager who had a large holding in Cisco. It had dropped 40 percent, and the chart looked terrible. The portfolio manager told me, "I know the management, the business model, the products, and the forecasted growth. Long term, this is a great investment. I am not selling my position. In fact, I just doubled the size of the position." Portfolio managers can and do think this way and act accordingly.

But traders, market makers, and specialists have to deal with the news and what it is doing to price. When that portfolio manager told his trading

desk to buy more Cisco stock, the traders were busy using technical analysis and charts to find the lowest price for the portfolio manager. And if they thought it was going significantly lower, they would have told that to the portfolio manager, not to change his mind, but to give him an opportunity to buy it cheaper.

Since portfolio managers are usually buying in size, millions of shares, they may be more interested in obtaining big blocks being offered, rather than waiting for the lowest price. It is very difficult to catch the exact bottom, especially if you are buying millions of shares. Usually, the big Wall Street sell-side trading desks will call portfolio managers who are buying Cisco and offer them a large block of shares at a certain price. Buying the large block now available may be more important than hitting the lowest price and waiting patiently for small blocks to be offered to accumulate a position of millions of shares. Portfolio managers may have to overpay for a stock but the small investor does not. He can buy close to the bottom and sell close to the top. The portfolio manager will be in a stock too early and out too early for good reasons. Technical analysis can help the portfolio manager in this regard, but not as much as it can help the small investor.

THE FACEBOOK IPO GAME

With that background, let's return to Facebook. The usual game is to be in on the deal and obtain the stock at $38 and then "flip it" for a quick profit after holding it for a reasonable amount of time. Everyone was dreaming of another LinkedIn and possibly doubling their IPO investment.

Despite bad news from Facebook, just before the IPO, instead of decreasing the price and shares of Facebook, the underwriters increased them! While the underwriters' analysts were busy downgrading Facebook just before the IPO date, the owners of the stock to be sold on the IPO date were pushing for higher prices like $38 and a 25 percent increase in the amount of stock to be sold at this inflated price.

The fundamental analysis for Facebook had to forecast two years out to come up with any numbers that might be used to rationalize the value of the stock. Even then, the $38 looked "very rich"; that is, it looked too high because it could not be justified by the fundamentals. One analyst had a 12-month target of $44 and another $48. These were very low targets, relative to the IPO price of $38, for stock growing revenues at 50 percent. It meant the $38 price was too high for these analysts. The $28 price was closer to the correct IPO price.

Early investors, the venture capital firms, were making enormous gains on their original investment; some had a cost basis of pennies for

the shares they were selling for $38. Some had indicated they would sell 50 percent of their holdings at this price. They were dumping their holdings at near $38. This was another red flag that Facebook price would drop after the IPO. Plus, almost everyone who wanted the stock before it came public at $38 was surprised when their orders were filled, a signal to the professionals that there would be no shortage of the stock on the open and that price would not soar and certainly would not double as LinkedIn did on its IPO day. There was just too much stock available to "flippers," typically high-net-worth retail accounts, hedge funds, and traders. Institutions usually hold on to their IPO shares, at least for a short time until they can sell into strength or double their position on any weakness.

FACEBOOK SELLOFF

The stock finally opened at $42, to trade momentarily at $45, and then dived down to trade at $38. The Nasdaq had trouble opening trading so it is not surprising that $42 was incorrect for an opening price. There was a quick chance to flip this at a small profit. Adding to the misery, the Nasdaq market system failed, and some traders and investors were not able to receive confirmations. They were flying blind on their trades. The stock made a couple of attempts to return to $42, helped by buying from the investment bankers to support the falling market price. They were overthrown by the sellers, and luckily the underwriters were able to hold the price at the close above the $38 IPO price. It closed at $38.23, as shown in Exhibit 5.1.

You did not need a chart to tell you that supply was more than demand, and that is why price came down from $42 to $38.23 close. Price moves and volume were spelling "supply." Therefore, it was no surprise to see there was still plenty of supply around on Monday morning when Facebook

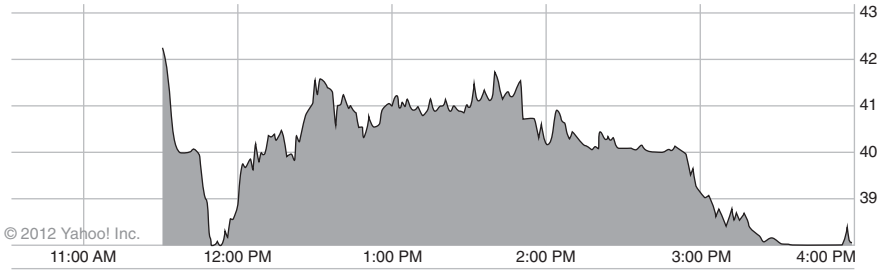

EXHIBIT 5.1 FB, May 18, 2012, Intraday
Source: Yahoo.com.

opened at $36.56, down from the prior close of $38.23, and quickly went down to $33. After that wave of selling passed, it's likely that the investment bankers, among others, started buying and price closed the day at $34.03, down 11 percent.

Those who were in on the deal at $38, the IPO price before coming public, were losing money if they failed to sell on the open Friday at $42 or before the close at $38.23. Those who bought on the open at $42 and failed to sell were looking at a 19 percent loss. The small investor who bought at $42, on the open of trading, looked like the victim of a "sting" operation that was playing on the greed of the victims, orchestrated by Facebook, its insiders, venture capitalists, and the Wall Street underwriters. This was a disgraceful display of *pumping and dumping* Facebook stock at $38.

Most traders and flippers were probably sold out on Friday with little or no loss. Early in the afternoon, it was evident that, from their perspective, the IPO was a flop. From Facebook's perspective, it was a $6.8 billion enormous success because they optimized the price and the number of shares sold at $38. The insider stockholders, who were unloading shares at $38, received $9.2 billion from the IPO. This included $1.1 billion for Mark Zuckerberg, the Facebook founder and CEO, who sold 30 million shares but still had 504 million shares more.

The portfolio managers, who bought it for the long term, are concerned they paid too much. They may be embarrassed by the drop in price, but they may also double up on their position when price finally bottoms, much like my Cisco portfolio manager. Many portfolio managers refused to participate based on fundamental overvaluation of the stock. Other portfolio managers sold as soon as they realized it was a "busted IPO" and they had been victimized by Facebook, its early investors, and the underwriters. As the price comes down on Facebook, portfolio managers who refused to buy at $38 may become interested at $28 or lower. Or they will take part in the final *exhaustion selling* marked by enormous volume when every investor finally throws in the towel and price has reached the very bottom.

FACEBOOK DIVES BECAUSE OF SUPPLY

What is the purpose of the Facebook case study? Very simply, learn that price is determined by supply and demand, not necessarily by fundamentals. Reading the tape, block trade by block trade, or looking at the order flow tells you real time whether the sellers or the buyers are moving price. Once you have learned about supply and demand, you will never again ask, "But the earnings were great—how come the price is going down?" Technical analysis of supply and demand tracks price in the short term. In the long

term, the market eventually becomes efficient and the price trades based on the fundamentals. Technical analysis spots the secrets moving the tape, whether those secret forces are portfolio managers, rumors, insider trading, or whisper numbers. Unless you have billions to invest and are paying enormous fees for research, or you have contacts with the trading desks, you will never know or read about what is moving price until it is too late. Only technical analysis will give you that information. It will give you the answer in terms of supply and demand, and without ever knowing the "secrets" that are moving price. In the case of Facebook, we will discuss these signals in this chapter, namely, moving averages, OBV, accumulation/distribution, CMF, MFI, and candlestick charts.

Can the technical signals be manipulated? Yes, they are moved by high-frequency trading computers, phony bid and asked orders, or low volume when it is easy to place a market order and move price significantly. But technical analysis can warn you of the false signals. That is what needs to be learned, namely, how to use technical analysis to avoid the false signals, eliminate the *short-term noise* that is the chaos in real-time trading, and see the real underlying supply and demand that will continue to determine price. The false signals in technical analysis—the false signals in supply and demand—have made the market very inefficient. Prices are more volatile. Maintaining an orderly market is almost impossible for stocks where the short sellers are attacking or where the high-frequency trading robots have identified a victim. Negative or positive news also creates *inefficient markets*.

TRADERS LOOK FOR INEFFICIENT MARKETS

Traders love inefficient markets because they can make easy money as price bounces around. Investors hate inefficient markets because they have to overpay for their buys and receive less for their sells. Perhaps someone has figured out what portfolio managers are doing and is able to front run their buying and selling. If someone knows you are selling a million shares and you have only sold 100,000, they can jump in front of the rest of your selling (called illegal front running); sell the stock short, knowing that the rest of your sell program will take the price down; and then cover the short when you are finished selling your position. Portfolio managers avoid this problem by selling their complete position to the institutional block trading desks willing to buy a very large block of stock at below-market prices, knowing they can sell it at market or above to make a profit.

If you are using technical analysis signals and public data to pick up increasing supply of the stock caused by a sell program, then there is no

problem front running, because you actually don't know the details or have insider information. All you know is that supply has suddenly increased and is taking price down. The chart, technical analysis of price and volume, will tell you when the seller is done. If there is unrelenting selling by more and more sellers, the chart will tell you that. You can front run their selling. Likewise, if there is unrelenting buying, the chart will show price going up, and you will be able to front run the buyers. The easiest trading for day traders is when there is wave after wave of buying taking price up. Portfolio managers need to be in the stock and have decided to chase the price because of some breaking news. We showed a good example of this in Chapter 2 when Google started its move up from a bottom after a positive surprise.

That is what day traders do all day long. They take advantage of the buyers and the sellers when there is big news on a stock. When there is no big news, they help to keep the market efficient, buying on weakness and selling into strength. For every buyer there is always a seller, and vice versa. What tips you off to demand or supply is which way the price is going as the stock trades and how much volume is involved, indicated by OBV-type signals.

FACEBOOK SECRETS TOOK PRICE DOWN

In the case of Facebook on IPO day, the price was set by the underwriters at $38, which means if your broker were able to deliver to you an allotment of the IPO, you bought it before the open at $38. The stock opened at $42, and if you bought it on the open, you paid $42. If you bought it on the close of trading, the price had dropped to $38.23. Supply and demand, as measured by technical analysis, determined the roller-coaster ride in Facebook price on its IPO day, as shown on Exhibit 5.1. Fundamentals had nothing to do with it. Buying by the underwriters kept the price artificially high at the close, so it did not close below $38.

The secret playing out in the market price fluctuations that few people acknowledged was that the price of $38 was too high. Most buyers had been filled at $38 before the open and were ready to sell when it opened. You did not have to know these secrets because technical analysis would identify supply and demand moving price in the first hour of trading and that was more important than knowing the secret forces that were moving the market. The drop right after the open from $42 down to $38 on Exhibit 5.1 was the tipoff to the secret of supply overpowering demand to take price down.

Because most of the buyers were already filled and there were few buyers left, but plenty of sellers after the open, price dropped from $42 and

a momentary $45 high, to $38.23 on the close. In the next couple of days it dropped to $30.94. Finally, on Wednesday, the fourth day of trading, it bounced, indicating that for the time being the sellers were done and there was more buying than selling, more demand than supply. But the major technical sell signal was already in place and could be clearly seen on the candlestick (see Exhibit 5.4) the very first day. In this chart, the first day shows an ominous, black candle because price reversed itself, going up to $45 and then closing below its $42 open, ending the day at $38 on enormous volume. Sell signals of this magnitude are rare and overwhelming. Facebook was going no place but down. Technicians and traders knew this. The fundamentalists realized it was not another LinkedIn, just another very overvalued growth stock going down to a more reasonable price.

Before the IPO, Facebook made public their problems with mobile ads and revenue growth. Although the analysts' downgrades were not available to the public because you have to pay for their research to receive it, the problems were publicly known and revealed by Facebook. Before the IPO, some analyst, not associated with the underwriting firms, had a 12-month target of $44 for Facebook. That implied that if you were looking for 50 percent growth in Facebook, the current growth rate, the price should be lower than $38, perhaps closer to $28. *This analyst had given the public a "heads up" before the open of trading for Facebook.* It told them not to buy at the $38 IPO price and certainly not the $42 opening price. Maybe in 12 months it might be worth $44, but certainly not on the opening day of trading.

FACEBOOK: THE RUSH TO SELL ON THE FIRST DAY

When Facebook opened for trading, the demand for shares was greatly diminished because so many shares were issued at $38 before the opening bell at $42. Many high-net-worth individuals had received their full allotment requested, which they did not expect to happen. For example, usually if you asked for 1,000 shares of a "hot IPO," you would only receive 500. As a result, they needed to sell immediately the excess shares requested but not really wanted. The only demand left on the open at $42 was the small investor, who was not smart enough or big enough to receive an allotment. This demand could not help the IPO price move up, as a tsunami of selling from traders, flippers, and high-net-worth individuals came at the market.

Price fell and would continue to fall as long as there was a supply (i.e., more sellers than buyers), regardless of the intrinsic value of Facebook. There certainly would be no value buyers stepping up to buy this grossly overvalued stock. An article was published, with a low price target of $13.80 for Facebook, while it was trading at $32, and gave some indication

of the price that might interest some "growth at a reasonable price" (GARP) players.

FACEBOOK PRICE IN SEARCH OF A BOTTOM

Since the situation with Facebook is clearly a question of supply and demand that is determining price, there is no sense in looking at fundamentals to determine where price is going. Technical analysis can measure and identify supply and demand, using volume and price movements. The 5-day (see Exhibit 5.3) shows price stabilizing at the $31 to $33 range. At least for a couple of days there is some equilibrium between supply and demand, possibly created by the underwriters supporting the price. Technical analysis will tell you when that changes. Price and volume will tell you when that changes. If supply increases, price will go lower. If volume increases as price goes down, you will see the supply in action. If the insiders with currently locked-up stock start selling, technical signals will go off. The reverse is true for demand, and as demand goes up, price goes up accordingly.

The Facebook IPO case study provides a unique picture of supply and demand in action to determine price. The fact that the price was overvalued based on the few existing analyst targets and their opinion of the fundamental metrics, as well as a casual look by any investor at the growth rates and bloated price-earnings ratio (PE) for Facebook, may have resulted in cancellation of many orders just before the stock opened. Thus, demand decreased because price was raised to $38 from $28. But the decision to increase the supply of stock by 25 percent a day before the open was the tipping point where demand on balance turned to supply on balance and quickly took the price of Facebook down below the $42 open to test the $38 IPO offering price on the very first day of trading.

The key indicator of this supply was the drop in price on high volume from $42 to $38 right after the open on day 1. The only reason $38 held was that the investment bankers responsible for the IPO probably came in and supported the price by buying shares. On Monday, the second trading day, the price dropped on the open and the supply overwhelmed the bankers' ability to support price at $38. Price will stop dropping when the supply of stock, caused by the sellers, is exhausted. In technical analysis, *exhaustion selling* is usually identified by an enormous drop in price and a very big spike in volume, identifying a temporary bottom in price. Only time will tell whether the bottom is temporary or permanent.

On Tuesday, May 29, after the holiday weekend, the seventh trading day, Facebook dropped from $32 to $29, as shown in Exhibit 5.2.

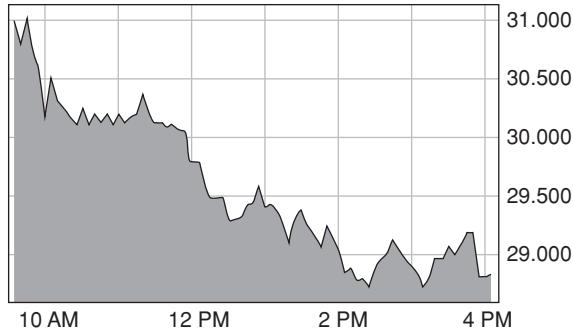

EXHIBIT 5.2 FB, May 29, 2012
Source: Yahoo.com.

WHY IS PRICE GOING DOWN?

Once you understand, from a startling case such as Facebook, how supply and demand moves the price of a stock, you will never ask why a price is going up (because there is demand!). Nor will you ever wonder why price is going down (because there is supply!). You may not understand or ever know the reasons causing the supply or demand, but price changes and volume will certainly identify supply and demand. If there is one thing technical analysis does perfectly, it is to identify supply and demand. That is why traders use it.

Those who see the order flow don't really need technical analysis because they see demand and supply developing before it ever hits the tape. Technical analysis sees it after it hits the tape. High-frequency trading and black boxes, with their secret programs, may also see it before it hits the tape depending on the sources of their data. If the black boxes are receiving proprietary, in-house data from their institutional trading desks, they may identify moves before they hit the tape. This would be a form of high-tech front running that is illegal. As an auditor in a former life, I can tell you this is very difficult to catch unless some computer programmer "blows the whistle."

It may be difficult to identify and even more difficult to prosecute if it is illegal front running of customers' trading desk orders. However, the black box (secret computer code) may simply be using technical analysis data faster than other automated systems. Obviously, a black box does not need or use a chart. Thus, a human being reading a chart has a big advantage over the black box, but the black box has speed. Most traders are dependent on charts or the tape. A few have black box systems, using their proprietary algorithms (computer programs) to analyze the data and produce a buy or sell signal for short-term day trading.

SEEING DEMAND/SUPPLY ON THE CHART

One of the most popular methods of keeping track of supply and demand is using moving averages such as the 50- and 200-minute on the 5-day chart (Exhibit 5-3). This chart shows daily trading for Facebook. The first two days' supply and demand are in relative equilibrium, and price is going sideways to slightly up. But then the trends turn down, indicating that significant supply is taking price down. First price breaks down, and then the 50-minute moving average falls below the 200-minute and keeps falling. No question that supply is in control, and the sellers, on balance, are taking price down. The downward trends indicate this is not a random happening but a change in trend. Day traders will keep selling (shorting) every time price bounces up because they believe *the trend is your friend*. If the trend is down, traders will sell (short) every bounce up in price.

As you can see, the downward trend did not change, indicating that the market was not able to handle the sellers except by dropping the price to find a buyer. The 200-minute trend is the line well above price in Exhibit 5.3, and the 50-minute trend is hugging the price movement. Until these turn up, the supply indicated by the downtrend in prices will continue to take price down. Once the supply is exhausted, then the demand, on balance, will stabilize prices, and any increase in demand will raise prices. Usually, news stories will be the triggers for increased demand. But sometimes the story moving price up may not be announced for days. *Those who know don't talk; those who talk don't know*.

EXHIBIT 5.3 FB, May 30, 2012, 5-Day
Source: Yahoo.com.

But if a portfolio manager receives a call from a sell-side analyst/trading desk/sales trader with a compelling story and decides to buy millions of shares, it will appear on the chart. As the sell-side analyst or his sales traders call more and more portfolio managers, who start buying after the call, then demand will really take price up, turning the 50-minute and eventually the 200-minute back up.

Usually, the sell-side analyst will be selling a fundamental story to the portfolio manager, but not always. As this Facebook chart shows, sell-side analysts are not convincing any portfolio managers to buy Facebook at this price, at least not enough to fully absorb the supply provided by sellers. The sell-side analysts at brokers receive large sums of research money from portfolio managers and their buy-side analysts. The sell-side analysts are not about to give this information away free on TV or to reporters. They will give it away free once all their paying clients know about it. That's adequate for the small investor because it is still valuable research but it is no longer timely research when you hear it on TV.

When you hear it from an analyst or a portfolio manager on TV, it is already old news, and most of the professional buys have already crossed the tape and appeared on the technical analysis chart. The small retail investor is the last to know, but if they are buying for the long term, they can wait for the next selloff in the market and use the free research to buy the stock cheaper. By the time it is touted on TV, price has already run up on the news and traders are ready to play the selloff. The chart will always tell you whether you are receiving the earliest information or the oldest last call before price dives down again.

The selloff in Facebook is a good example of how the small investor can wait for a big selloff and buy a stock like Facebook much cheaper than $38. Technical analysis will tell you when the price of Facebook reaches a bottom where it can be accumulated. Better yet, it will show you how to wait so you don't park your money in a stock that bottoms for a long time, hurting your performance. Technical analysis signals will tell you when the bottoming is over in Facebook and price is once again ready to start an uptrend.

WAITING FOR BUY SIGNALS

The signals that will tell you it is time to buy Facebook are many. First, the downtrend in the moving averages must change, first to sideways and then to up. Thus, the 20-day, then the 50-day, must turn up. Then the stock must start outperforming the market. Price must be moving up better than the Standard & Poors (S&P) 500 Index and the Nasdaq, which is good relative strength. Portfolio managers like to buy outperformers. Money flow

indicators discussed later in this chapter—such as OBV, accumulation/distribution, and CMF—need to show a positive trend.

In all likelihood, the first bounce up from the bottom by Facebook will not be the last. It will probably return and retest the bottom, forming the famous "W" bottom. These same technical signals will warn you when a bounce up runs out of steam and price turns down to retest the bottom. When you have a longer history of price and volume for Facebook, there are many other technical signals that will be useful. The 200-day moving average is the important long-term signal. (Some prefer the 150-day to receive an earlier signal.)

PICTURE OF A "BUSTED IPO"

In Exhibit 5.4, you can see the picture of this busted IPO and what supply did to the price of Facebook. The IPO was very successful for Facebook, Mark Zuckerberg, and early investors, who were selling the stock at $38 to

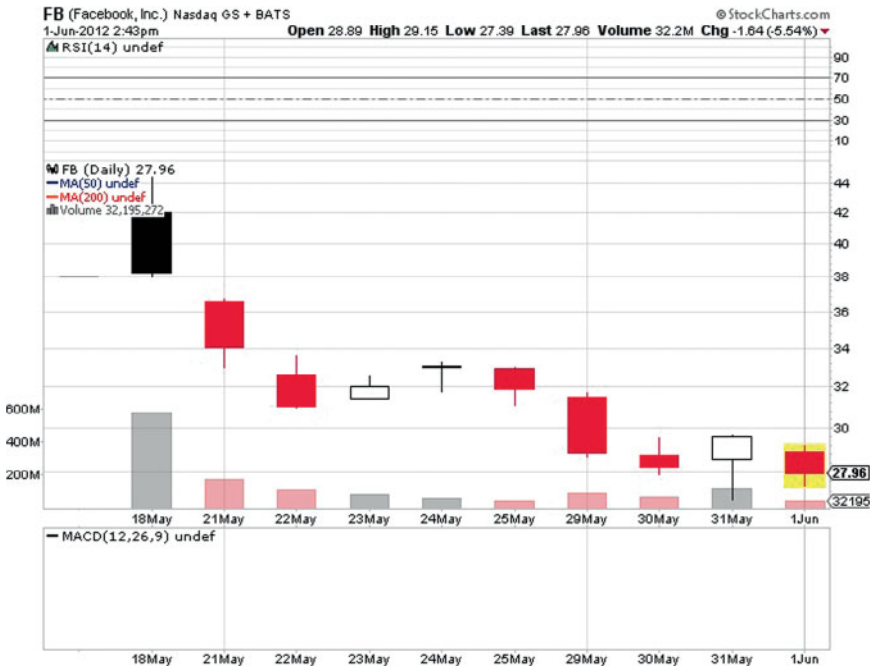

EXHIBIT 5.4 FB, June 1, 2012, Daily
Source: StockCharts.com.

the public. A busted IPO is when the public is stuck with losses as the price quickly drops below where Zuckerberg and friends sold it.

Technical analysis always presents the picture of supply and demand. Fundamental analysis is only one of many factors that create supply and demand. Fundamental analysis alone will never explain why price is where it is at any given moment. Only supply and demand can do that, and only technical analysis can give you that picture. The big black candlestick sell signal (a reversal signal) on the first day and the following red candlesticks on the chart show price dropping and identify the supply in the market driving price down day after day.

Notice in Exhibit 5.4 on May 31, almost two weeks after the IPO, the white candlestick positive hammer profile and increasing volume are the first significant signal that buyers, on balance, were active. The first sign of more demand than supply was probably because the sellers were temporarily exhausted, or the shorts were buying to cover their short positions. Technical analysis doesn't really care what the reasons are for the supply or the demand. Technical analysis is only interested in identifying it as early as possible, determining whether it is significant (not a false signal) and trading ahead of it.

POINT & FIGURE CHART SHOWS CONTINUED SELLING

Notice in Exhibit 5.4 that there are bounces up in price. Stocks going sharply down, or up, have these little bounces when going down and little pullbacks when going up. Day traders will trade them, as well as the specialists and market makers. If you are looking for the bottom in Facebook, that is, the final low price where Facebook will go no lower, then you need to use a tool like the Point & Figure chart shown in Exhibit 5.5. Notice that the Point & Figure chart is not fooled by reflex bounces as the price is going down. Note that the X's appear when price is moving up, to $45 for Facebook. The O's are for price moving down. The switch from the X column to the O column happens when price drops 3 boxes or 3 points in this case. As you can see, as far as this chart is concerned, price is still going down, uninterrupted by the occasional bounce up of less than 3 points.

Even more valuable was the answer the Point & Figure chart gave on the first day of trading for Facebook. It first recorded the O column when price dropped from $45 to $42 early in the trading after the open. Notice that this negative signal warned traders of what was coming, namely, a test of $38. Price came below $39 and then bounced up but never reached $42, so the O column again warned traders that this was just a minor bounce up and price was going back down again. Once other short-term indicators

Facebook, Inc. (FB) Nasdaq GS
01-Jun, 16:00 ET, daily, O: 28.892, H: 29.15, L: 27.39, C: 27.72, V: 41.8M, Chg: -1.88
No New P&F Pattern
Traditional, 3 box reversal chart

46.0							46.0
45.0	X						45.0
44.0	X	O					44.0
43.0	X	O					43.0
42.0	X	O					42.0
41.0	X	O					41.0
40.0	X	O					40.0
39.0	X	O					39.0
38.0	X	O					38.0
37.0		O					37.0
36.0		O					36.0
35.0		O					35.0
34.0		O					34.0
33.0		O					33.0
32.0		O					32.0
31.0		O					31.0
30.0		O					30.0
29.0		O					29.0
28.0		O					28.0
27.0		O					<<27.72
26.0							26.0

EXHIBIT 5.5 FB, June 1, 2012, Point & Figure
Source: StockCharts.com.

showed the bounce up was over, the Point & Figure chart was encouraging traders to short the bounce because the bearish O column was looking for a continuation of the selling.

This is not a foolproof signal—no signal is. It is just another piece of the puzzle in deciding whether the bounce up was an opportunity to short because price was going back down to retest $38 to $39. The final retest was the closing price for the day at $38.23, confirming that the sellers were now in control and the buyers were done. Facebook was going lower until the sellers were exhausted. Below $42 brought in the sellers who had bought on the open at $42 and were now losing money. Below $38 would bring in the sellers who had received an allocation at $38, the IPO price, and would start losing under $38.

Because Facebook flooded the market with 421 million shares, it would take the sellers many days to unload their now losing positions in a stock they expected to flip for a quick profit. Supply would continue to take price down, not necessarily fundamentals, although one analyst would create even more supply by coming out with a "sell" and a 12-month target of $25, while other analysts had targets of $44 to $48. The $25 target implied that Facebook should be trading around $17. The fundamental analysts were split, with targets anywhere from $25 to $48. Price would continue to drop as the market looked for a price that would find a balance between supply and demand. Eventually, the market would become efficient and settle on a bottoming price for Facebook. That price was not predictable.

The first significant bounce up will occur when the X's show up again on the chart in Exhibit 5.5. The date of this chart is Friday, June 1, two weeks after the IPO came out. That is because the Point & Figure chart requires a 3-point move up before it will recognize a bounce up. That probably will not identify the bottom for Facebook, but it will be the first indication that Facebook is moving close to a bottom. For traders, this neat chart also tells them that the weak bounce up, less than 3 points, should be shorted because price is going lower.

As price goes lower, fundamentals will become more important and eventually will establish an efficient market price for Facebook. By that time traders will have made a fortune using technical analysis to determine demand-and-supply moving price. As price goes lower, more analysts will come out with buy recommendations on Facebook. Eventually, the sellers will be exhausted and buyers will be listening to the case being made by fundamental analysts for targets like $40, $44, or $48.

If Facebook bottoms at $20 and the sellers are all gone, then new buyers interested in the possibility of doubling their money will create the demand to take price up. Fundamental analysis is only one factor that may move the price of Facebook up, but it certainly is not the only factor. Any portfolio manager who uses only fundamental analysis will have a tough

time beating the index benchmark for his style of money management. That is the lesson of Facebook for every portfolio manager and investor.

Day traders already know this. If investors and portfolio managers had paid more attention to supply and demand and what the investment bankers did to create enormous supply, they would never have bought Facebook at $38. As a matter of fact, one of the reasons the Nasdaq system failed on May 18 with Facebook IPO trading was the large number of canceled orders by those who realized the supply debacle that was created and they did not want to own Facebook at $38 or $42 on the open.

ON-BALANCE VOLUME

Price is not the only way of measuring supply and demand. Facebook has not traded long enough to use many of the useful technical analysis "secrets." But there is another time-honored method of identifying supply and demand called *on-balance volume*. It is a very simple concept. If price is going up, that volume for the time period (five minutes, one day, one week, or whatever) is counted as positive. Likewise, if price is going down during the period, that volume is counted as negative. The running total is plotted on a chart, and the changing direction, up or down on the chart, identifies demand that will take price up or supply that will take it down. Note in Exhibit 5.6 that the line has not moved up, indicating supply pressure on price as measured by positive and negative volume. OBV is calculated at the end of each day for a daily chart as shown here.

Sometimes this signal will lead; that is, it will happen ahead of the price movement. Since trading is all about running ahead of price movements to make a profit, any signal that is a leading indicator is one of the most valuable secrets in the technical analysis tool kit. The search by technicians is always for reliable leading indicators. They are very difficult to find.

ACCUMULATION/DISTRIBUTION

Another signal that keeps track of supply and demand is the accumulation/distribution signal. It is similar to OBV in that it is a cumulative calculation; each day's result is added to the next to plot a total. In OBV, the calculation is a cumulative volume total, going up or going down based on closing price being up or down. However, with accumulation/distribution they are allocating volume based on how close the closing price is to the high-low price range and the volume multiplied by this ratio, which is calculated on where price closed relative to the high and low of the day. Each day is

EXHIBIT 5.6 FB, June 6, 2012, Daily
Source: StockCharts.com.

added or subtracted to plot a cumulative volume line just like on-balance volume. If the volume is positive, the line will start to move up; if it is negative, the line moves down.

On the chart in Exhibit 5.6, you can see that accumulation/distribution is down, has not turned up, and is therefore negative, indicating supply pressure on price. Gaps up and down are problematic for this calculation but not for OBV. What is problematic for OBV is a small change in price. A better way to compute volume is to combine both calculations, taking advantage of the strengths of both and eliminating the weaknesses.

There are many such systems for measuring money flow, and some are better than others. For many years I marketed a black-box secret calculation of money flow to portfolio managers. Marc Chaikin developed the money flow calculation being used here by StockCharts.com, and its calculations are not secret. Joe Granville was a strong proponent of OBV back

in 1976. My favorite signals are ones that identify supply and demand, or money flow, both short term and long term. Short term is for traders, and long term is for portfolio managers or investors. Daily and intraday charts are for traders, while weekly and monthly charts are for investors. Day traders are using the minute-by-minute chart to trade.

SUMMARY PICTURE OF SUPPLY AND DEMAND

Exhibit 5.6 shows OBV and accumulation/distribution measuring the supply that continues to take price down. Note that the starting point of these indicators is problematic because this is an IPO with no price history. Both indicators are using cumulative totals, and you will see demand when they turn up. The starting point tells you nothing. You are just looking for a change in the slope of the line—a change in direction.

In addition, supply and demand is created by the overall movement of the market. This chart shows the movement of the S&P 500 Index, so you can visually see if the up or down market is creating demand or supply for Facebook. At this point, Facebook has traded for only a few weeks; many other daily technical analysis signals are not yet available.

As you can see from the 5- and 10-day moving averages in Exhibit 5.6, price has not yet broken above these very short-term indicators. If the trend is your friend, it is indicating continued supply leaning on price. Likewise, OBV and accumulation/distribution have not improved yet, confirming continued supply pressure.

FACEBOOK'S FIRST EARNINGS REPORT

On July 26, 2012, Facebook reported its much anticipated quarterly earnings. As Exhibit 5.7 shows, during June, there was a dead cat bounce up in price to $34 from the temporary bottom at $26. The first wave of selling was over, and low-volume demand took price up—a bearish volume indicator.

There were hopes that the first earnings report would recapture the growth promise of Facebook. But as the earnings date approached, supply once again took price down to test the bottom at $26. No surprise here because after a major selloff, it is highly likely that price will retest the bottom to confirm the bottom is in place (and the next bounce up may be the beginning of a positive change). After a major sell signal, such as the one for Facebook on its first day of trading, it was more likely that price would fail on the test and a lower low would be put in place still looking for a bottom.

EXHIBIT 5.7 FB, July 27, 2012, Daily
Source: StockCharts.com.

As Exhibit 5.7 shows, the earnings report was disappointing, lacking any forecast for the next quarter. The sellers promptly took price down on July 27 to a lower low at the $23.70 close, confirming that the bottom was not yet in place for Facebook. Instead, volume and the gap-down in price confirmed another major sell signal on the chart, but a sell signal not as strong as the one on the IPO day.

CMF SIGNAL

After earnings, Facebook gapped down from $26.84 to the $23.21 low for the day. What were the technical signals saying just before earnings? The first sign of supply in Exhibit 5.7 is indicated by the downtrend in the short-term 5- and 20-day moving averages, with the 5-day bearishly

crossing below the 20-day around July 13, when price was just above 30. This provided plenty of supply warning before July 26. The CMF turned red below the line on July 16 and continued moving deeper into the red right up to July 26.

MFI AND MACD SIGNALS

The MFI, shown at the bottom of Exhibit 5.7 was a leading indicator, turning down from overbought on the week of July 2 and continuing a downtrend until the earnings announcement. Notice that during the week of July 2 price was going up as the MFI signal was going down, moving from overbought to oversold, a negative divergence that correctly identified that the price move up was a false signal and a minor *bull trap*. It would kill those buyers.

The moving average convergence/divergence (MACD) signal in Exhibit 5.7 is more subtle and very late, but very powerful for the short-term trader. Notice that the MACD is negative, with the bars below the line, but showing slow improvement from deeply negative. Then the day before earnings, a very late signal, but still ahead of earnings, it turns down. Instead of an improving bar, it shows a reversal and puts a more negative bar in place, below the previous day's bar. Whenever this reversal in an improving MACD pattern happens, watch out because it signals price is going to reverse—in this case, go down instead of improving.

GRAVESTONE DOJI CANDLESTICK SIGNAL

On July 9, Exhibit 5.7 has a gravestone doji candlestick, an upside-down "T" profile, at $32, which is a reversal signal indicating that the positive white candles may be finished. The rest of the week turns out to be negative red candles (supply) and on July 16 a really big red candle just to make the point. The candles go sideways for over a week, and then the day earnings are to be announced, there is a gap-down in price on the open and a red candle identifying the selling. Earnings were announced after the close on this red candle (bearish) day. The next day, July 27, price opened with a gap-down of more than 3½ points.

This chart is exceptional in the number of technical signals that were showing supply taking price down before the negative earnings announcement. Probably the reason there were so many negative signals before earnings was that Facebook was already in deep trouble with supply and the additional supply just triggered many signals before earnings. Don't

expect to see this kind of clarity of signals for most other company earnings unless there are already supply problems before earnings, as in the case of Facebook.

PIVOT POINT SUPPORT/RESISTANCE LEVELS

One final point on Exhibit 5.7 is that the support level S2 established by the pivot point signal did identify very closely where price dropped to after the market's displeasure with the earnings report. Notice that the gap-down in the chart goes down to test S2, identified as $22. When price did not hold at the first identified support, S1, the gap-down in price took it to an immediate test of S2.

In this case, the pivot point methodology provided added value in correctly identifying resistance at R1, near $34. Support was near $26 at S1 and near $22 at S2 on the chart. Pivot point support and resistance levels are merely guides rather than accurate predictors of support and resistance. In this case, they were very close to being right. Don't expect this to happen too frequently, as the pivot point calculations were originally designed by brokers on the floor as a quick way of giving them a guide for support, resistance, and a pivot point where price might reverse its short-term trend.

DAY–TRADING SIGNALS

The next Facebook chart (Exhibit 5.8) on July 27, 2012, is the intraday chart showing how it traded the day after the earnings conference call that failed to give investors any forecast for the next quarter. An established winner like Google can do this, but not a new busted IPO like Facebook.

The price goes to a low of $22.28 right after the open, down from the previous close of $26.84, which can also be seen in Exhibit 5.7. In Exhibit 5.8, there are high spikes in volume supporting this sell signal in price—all signs of supply taking price down. But now notice around 11:45 A.M. the buyers come in and take price back up to $24.54 by 12:30 P.M. The volume increases but then falters, but price never goes back to the lows and closes at $23.70. The MFI at the bottom of the chart starts its move up from nearly oversold at 20 on the MFI signaling the demand that will take price back up to the high of the day. Then the MFI hits overbought at 80 on the scale and tapers off, providing a negative divergence to price, which closes relatively high on the day.

EXHIBIT 5.8 FB, July 27, 2012, 5-Minute, Intraday
Source: Yahoo.com.

This demand is surprising. You don't know what is creating it, nor as technicians do you care. You are interested only in measuring it to determine whether demand or supply will be driving price short term. Longer term, you have nothing but sell signals in place for Facebook. Short term, there may be buying created by those who sold the stock short. These shorts may be buying at these low prices and thereby booking their profit on the short. Also, there could be bargain hunters or portfolio managers who are averaging down. They bought Facebook at $38, and now they are buying at $24 to give them an average cost price of $31. The lower average cost of $31 looks much better on their books than the $38 they originally paid on the IPO purchase price.

From a technical analysis point of view, it is usual for price to make an attempt to return to a very important support level it broke. In this case, Facebook broke $26, a level many thought was the bottom of the selloff from the $38 IPO price and the $42 opening price on IPO day.

Now price is attempting to fill the gap-down from $27 to $22 and reach back up to test $26 again. Price will usually make an attempt to fill a gap. However, with the major sell signals showing on the daily and weekly

charts, most technicians would expect this move up to fail, thus making it a bull trap, a false move up that will attract buyers and then disappoint them. When this technical bounce up is finished, traders will watch for the technical signals to sell it short again, from $26 back down to $22. More likely, it will be from $25 down to $23, as price only retraces half of the gap-down and support is probably closer to $23 than $22.

TREMENDOUS SUPPLY OVERHANG

Finally, there was another big source of supply overhanging the Facebook IPO, and that was stock that was locked up but would soon come on the market. Company employees and some venture capitalists may not be allowed to sell their stock on the market for three to six months after the IPO. Estimates are that anywhere from 500 million to 1 billion additional shares could come on the market, taking price down should these insiders decide to sell in large numbers. The Facebook IPO was for 421 million shares, but there are almost 2.1 billion shares outstanding. Mark Zuckerberg owns 504 million of those shares. He sold 30 million shares for $1.2 billion as part of the IPO. He and others have a great many shares to sell in the future. Technical analysis will detect the selling by insiders as will the filings with the Securities and Exchange Commission.

SUMMARY

In this chapter, we emphasized the use of volume and price to identify supply and demand. The following technical signals were used: 50- and 200-minute moving average trends for day trading, candlestick signals, OBV, accumulation/distribution, Point & Figure charts, MFI, MACD, pivot point, and CMF. These signals were used in the case study of Facebook starting at its birth as a stock, trading in the marketplace after its IPO on May 18, 2012. On day 1, it became very evident that trading would be based solely on supply and demand and no other factors, including the most touted, namely, fundamental analysis.

Very rarely is it possible to eliminate most other factors from influencing price and see price move solely for a long period of time on purely supply and demand. In this case, every portfolio manager and every fundamental analyst must admit that fundamental evaluation was useless in determining price in the case of Facebook in the days following its IPO. When Facebook finally bottoms, fundamental analysis as well as many other factors will once again play a role in creating demand and supply.

But as the case study of Facebook shows, the IPO price and the volume of shares issued on the IPO day predestined the fall of Facebook because there was overwhelming supply created and very little demand left. Professional buyers had their fill of Facebook stock before it opened for trading on the IPO day.

Demand for Facebook stock by small investors drowned in a sea of supply and technical analysis determined price movements by tracking the supply and demand. The student of technical analysis was forced to use the very basic signals available on day 1: price, volume, relative strength, the Point & Figure chart, and, most important of all, the candlestick chart.

Successful Stock Signals for Traders and Portfolio Managers: Integrating Technical Analysis with Fundamentals to Improve Performance, Thomas K. Lloyd, Sr.

CHAPTER 6

Breakout Signals

Ascending Triangle, Bullish Rectangle, Double Bottom, and Falling Wedge, with Microsoft, Lululemon, and Home Depot Exhibits

The most important signals for investors, portfolio managers, and traders are the breakout signals. The stock market is all about change and recognizing change as early as possible so as to make money. Professionals have no interest in obvious trends that are showing no signs of change. It is "management by exception" for the portfolio manager and the exceptions are the stocks that have started to change. In this chapter, we discuss a former growth stock, Microsoft (MSFT), which is giving some signs of changing with a recent breakout. We will look at other stocks to demonstrate the breakout signals that are invaluable to everyone in the stock market. The case study stock will be the ascending triangle breakout of Home Depot (HD).

DOUBLE BOTTOM AND BULLISH RECTANGLE BREAKOUT

The Microsoft weekly chart (Exhibit 6.1) illustrates the following sequence of events:

- A double top at $30 followed by a drop of about 30 percent in price.
- A double bottom at $22.
- A bullish rectangle and positive breakout above $27 to $32, for an 18 percent gain.
- A breakout above double-top resistance at $30.

EXHIBIT 6.1 MSFT, April 13, 2012, Weekly
Source: StockCharts.com.

Exhibit 6.1 aptly illustrates why the double top and double bottom are widely respected and recognized patterns in technical analysis. As you can see, the double bottom has a "W" shape to it that we have outlined on the chart for you.

WHAT IS WRONG WITH MICROSOFT?

Microsoft is growing slowly, with its ubiquitous Windows operating system now just a bread-and-butter product. Price is going sideways while Microsoft scrambles to reinvent its former growth. Microsoft is a "cash cow" harvesting and updating its old products and trying to invent new ones as the personal computer (PC) is battered by competition from tablets, mobile devices, and cloud computing.

Microsoft is at a critical juncture just like Hewlett-Packard. Unless it copies IBM, which has successfully reinvented itself every 10 years or so, Microsoft will stagnate into oblivion like so many software companies before it. If Microsoft is successful, you will see it on the chart just as you saw it for IBM. Now let's look at Exhibit 6.2, which shows the MSFT flat line since 2001.

As Exhibit 6.2 shows, Microsoft is long overdue for a growth breakout. When you looked at the long-term chart for IBM, you saw this same deadly flat line in growth, where after 30 years IBM cumulative price performance had almost reached zero. It happens to the best of companies. Over the past five years, Microsoft has done better than the index, and it was a safe, fundamental stock in which to invest excess cash and beat the index. Portfolio managers want to know if this is going to change to the downside

EXHIBIT 6.2 MSFT, September 18, 2012, 25-Year
Source: Yahoo.com.

or upside. Exhibit 6.3 shows that it has just changed to the upside for the short term, and this coincides with the introduction of Windows 8.

The key to Apple's success is not only innovation but an ecosystem of products where the platform incorporates and connects all products. Microsoft had a similar ecosystem with its Office products and a near monopoly on the operating system used by most PC users. These advantages don't last forever, and Microsoft has lost the advantage that Apple has developed so well in recent years. Apple has introduced products that have stolen market share from the PC, which was the growth engine for Microsoft software. In addition, the cloud is taking market share away from the PC. It is no longer necessary to have an operating system or Office-type programs resident on the instrument one is using. Now mobile phones and tablets can access enormous computer power in the cloud; users are no longer limited by the programs stored on the PC, nor by the chip memory and speed. Microsoft and Intel are late to the mobile phone and tablet innovation.

Microsoft needs to develop a monopoly product in the cloud, on the mobile phone, or on the tablet, but monopoly-like products such as the Microsoft operating system happen only rarely. Now Microsoft has to compete in a world where it no longer has a monopoly and that is a very difficult switch from a corporate culture built on monopoly-like product growth. Everyone is ahead of Microsoft on all fronts. Portfolio managers have been waiting 12 years for Microsoft to do something. When and if it happens, the chart will show the breakout just as you saw on the IBM chart.

WHAT CAUSED MICROSOFT TO BREAK OUT?

Notice in Exhibit 6.3 that Microsoft has recently improved, with price breaking above the 2010 high. Price is showing demand, and you should be able to see that in other technical signals that measure demand. The first one below price in Exhibit 6.3 is the money flow index (MFI), and you can see it recently was in the green, extremely overbought, indicating that the demand that took Microsoft to a new high had peaked and price was ready for a pullback to test support.

The next signal below the MFI is the Chaikin Money Flow (CMF). This also surged in the green, indicating the demand that took prices higher. Now it is falling and price is falling because of the lack of demand. This signal confirms what you are seeing in price. The last signal is on-balance

EXHIBIT 6.3 MSFT, June 1, 2012, Weekly
Source: StockCharts.com.

volume (OBV). This uses both changes in volume and price to identify volume demand and supply. Notice the long downward trend in OBV was recently reversed. Changes in trend are always important. This change, going from downtrend to uptrend is confirming the new high in Microsoft price is important and the uptrend in the 40-week (200-day) moving average.

All of these demand signals and money flow signals are confirming that price is going up because of increased demand. As price pulls back, these signals are also pulling back. If they remain positive on the pullback, they will signal a "buy on weakness." As you can see on the chart, price is pulling back to test the long-term uptrend, the 200-day moving average in blue, possibly because the press is critical of the Windows 8, the new version of Windows that is due out.

Technicians don't really care what the reason is for the pullback because such speculation may prejudice their desire for an objective view of what the chart is saying, that is, what supply and demand are saying. Note that this 200-day trend line recently changed from sideways to up in direction, and that is a very important signal change. As you can see in Exhibit 6.3, this happened in 2010 but quickly turned down and leveled off for 2011.

Also on the chart, to emphasize the strength of the recent move up, just look at the pivot point (P) and first resistance (R1) and second resistance (R2). Price broke above these two resistance levels to put the new high in place, and that is impressive demand taking price higher. Any pullback to test the 200-day will be a *buy on weakness* opportunity if the 200-day is not violated, reversing the buy signal.

There is one red flag on the chart. You can see that price has dropped below a major support level at $30. This was formerly a major resistance level formed by the double top before the big drop to $22. This support level should have held and it didn't. However, the 200-day moving average is much more important, and that is in an uptrend. Price is testing that uptrend, and as long as that support level holds, Microsoft is a buy on weakness.

To know where price is going, you need to measure demand and supply. In the Microsoft chart you have seen many signals of strong demand. This enables you to become proactive on the pullback in price that is currently taking place on the chart. If these positive signals are still in place after the short-term sellers are exhausted, then you are prepared and ready to buy on weakness at $28. This is a significantly better entry point than buying at the $32.5, the overbought top at R2, when everyone else was buying because of the news in the media. This is the way portfolio managers use technical analysis to buy low and sell high**.** If they don't use technical analysis to do this, then they hurt their performance numbers every time they buy and sell stocks for their portfolio. Technical analysis adds to performance by shaving points off every buy and adding points to every sell a portfolio manager makes.

FALLING WEDGE SIGNALS DOUBLE BOTTOM

In Exhibit 6.4, you will see an example of the falling wedge on the Lululemon (LULU) chart. It happens just at the bottom and is followed by both a short-term bullish move to the upside and then the longer-term bullish move up from the double bottom.

In Exhibit 6.4, not only do you have the bullish falling wedge but also the formation of the familiar "W" bottom as price comes back down to test the bottom. The "W" is completed as price moves up from the double bottom and breaks out to the upside above the "W" middle peak resistance at $62.50.

CANDLESTICK HAMMER A BULLISH REVERSAL SIGNAL

In Exhibit 6.5 for Home Depot, there is an opportunity to learn of the positive power in the candlestick with the hammer profile. Notice at the beginning of the chart, the beginning of the move up, just below the label "Oct" is the hammer-shape candlestick, a bullish reversal signal. Then just under "Nov" is a smaller one and another small one in "Dec"; notice that price goes up after them. This is especially important after price has moved down and the supply is gone and there is a transition to demand to take price up. Now we are going to use this chart for our case study of Home Depot.

EXHIBIT 6.4 LULU, September 4, 2012, Daily
Source: StockCharts.com.

EXHIBIT 6.5 HD, August 10, 2012, Weekly
Source: StockCharts.com.

CASE STUDY: HOME DEPOT ASCENDING TRIANGLE

Earnings were due on Home Depot, and price was showing a classical, bullish, ascending triangle on the long-term weekly chart before the earnings announcement, as shown in Exhibit 6.5.

Your challenge is to recognize this bullish signal and determine whether it indicates that a good earnings report is coming. Did the market know something? More important than guessing about the earnings is your challenge to formulate your strategy based on the actual earnings report. If price goes down after earnings, will you buy on weakness? If it goes up, will you chase it or wait for the next pullback? What will the portfolio managers do, and what will the traders do after earnings? What will demand and supply on the chart indicate after earnings?

A few days before earnings, a couple of analysts had dropped their earnings estimates and were below the mean analyst estimate of $2.92. This did not destroy the bullish ascending triangle in price just before earnings. In other words, the demand created by anticipated earnings was overcoming the supply created by analyst downgrades before earnings.

A valuation grid that I use analyzed all the fundamental and forecast numbers for me and classified Home Depot as a "fairly valued buy." The chart showed long-term buy signals in the 50- and 200-day moving average uptrends; short term, there was a bullish ascending triangle signal.

After earnings came out on August 14, 2012, I wrote the following article titled "Putting a Target on Home Depot" on MarketWatch.com, identifying the ascending triangle breakout and the possible future targets for Home Depot price movements.

Home Depot's chart is a beautiful example of an ascending-triangle breakout triggered by its good earnings report. StockpickerUSA.com's valuation grid, before earnings, rated it as a fairly valued buy with forecasted data in the top third of about 4,000 stocks. Now the question is what is a reasonable 12-month target and implied return?

Nasdaq.com shows how popular HD is with the analysts: Fourteen out of 23 analysts have it as a buy, and 13 of 14 have strong buys. Obviously, there are nine analysts who might upgrade based on these earnings. The analysts' targets stretch from $46 to $62 with a consensus of $57.5 before the current good earnings. Thus, a case could be made for a target higher than consensus.

Just before earnings, two analysts lowered their earnings forecast below the mean forecast of $2.92. Obviously, they may reverse themselves along with several other analysts who have earnings estimates below the mean. A quick calculation of a PE of 20 and earnings of $3 gives us a $60 target, just below the $62 high target of the analysts. At the current price of $55, a target of $62 offers an implied return of 13% which is not bad for most investors.

Let's go back to the charts for some help. The point-and-figure chart shows that after this run-up in price is over, it could come back down to retest $52-$53 support. If we buy at $52, we are looking at an implied return of 19%, which is certainly better. HD's price has a pattern of pulling back to the 50-day moving average, which is currently at $52. It may be as high as $53 by the time there is a pullback in price.

The gap opening today will probably be filled on any pullback, which would also identify $53 as the support level to wait for buying. The overall market is overdue for a pullback as indicated by the VIX and the double top resistance point for the S&P 500 (1415-22). Such a market pullback would take all boats down including the outperforming stocks such as HD.

Price is already breaking above the Bollinger bands and Keltner channels, so price is already overextended while showing such bullish signals. The question of how high the current move up will take HD is a difficult one to answer. Using the pivot-point upper resistance level on the chart, it is at 56.59. My guess is the $57.5 consensus target is a ceiling and price will not move above that without a pullback to test support at $53. Somewhere between $55 and $57.5 price will probably hit resistance and then pullback to test support. HD has already tacked on a 10% move up from the July low of 50. A 14% move up from that low is about all to be expected and that would be $57 short-term.

Conclusion: No question about Home Depot. It is outperforming the S&P 500. Both the 50- and 200-day moving averages are in uptrends. Good earnings were just reported surprising a few analysts.

It is fairly valued and has a 2% dividend to add to an implied return of 13–19%.

(Nothing in this article should be construed as a buy recommendation for HD. Analysts' targets, computer models, and chart signals can be wrong. Do your own due diligence and consult with a professional financial adviser before making any investment decision.)

As you can see in Exhibit 6.6, after earnings came out, price continued higher. All the positive signals before earnings were right, including CMF, OBV, and the moving average convergence/divergence (MACD). Likewise, the positive breakout of price above the pivot point (P) at $52 on the chart paved the way for price to test resistance at both R1 at $54.38 and R2 at $56 as shown in Exhibit 6.6. This latter test was an enormous signal of

EXHIBIT 6.6 HD, August 17, 2012, Daily
Source: StockCharts.com.

demand, confirmed by volume and a gap-open price move to the upside after earnings.

All these positive technical analysis signals were reflecting the demand you could easily see in volume and price. For those who cannot easily see it in volume and price, all these technical signals help you to see both demand and supply more easily and thus understand what is driving price short term and long term.

SUMMARY

There is nothing more important to a portfolio manager and a trader than breakout signals heralding the improvement in the trend of stock prices. In this chapter, you saw double bottoms, the falling wedge, the ascending triangle, the bullish rectangle, CMF, pivot point, resistance and support, 50- and 200-day moving averages, MACD, and MFI all pointing to the impending positive change in a stock's price trend.

The stock charts of Microsoft and Lululemon and the Home Depot case study all illustrate the technical analysis signals that all need to learn and use in order to take advantage of the breakout moves in stock prices. These signals simplify the task of reading what price and volume are signaling.

Successful Stock Signals for Traders and Portfolio Managers: Integrating Technical Analysis with Fundamentals to Improve Performance, Thomas K. Lloyd, Sr.

CHAPTER 7

Relative Strength Index, Stochastic, and MACD, with Lululemon Exhibits

Those who like to sell call or put options do so by trading around a core position in their portfolio. Usually, these stocks, like Lululemon (LULU), are long-term, uptrend, growth stocks. By using short-term indicators such as the relative strength index (RSI), stochastic, and moving average convergence/divergence (MACD), investors can make some additional money by selling (writing) calls or puts. Using these technical signals, an investor can determine when there is low risk in selling the calls and puts. That is, you expect that these options will never be exercised, and the money received for writing the options is banked as additional income and adds to the portfolio performance. Portfolio managers and individual investors using this option-writing strategy must know these technical signals perfectly.

Growth stocks in the retail industry seem to follow a familiar pattern. They find a very successful niche and exploit it by opening more and more stores to provide impressive growth that Wall Street loves. This is the case with Lululemon, and it has enough history to provide a little case study for technical analysis.

First, you want to look at the longer term (Exhibit 7.1) to see if the technical signals are similar to the ones you looked at for Apple and Google in Chapters 1 and 2.

Yes, the 200-day trend turns up in the middle of 2009. The sellers in red fail to even take price back down to test the 200-day until the end of 2010. Price bounces up again and does not retest the 200-day again until

EXHIBIT 7.1 LULU, June 8, 2012, 5-Year
Source: Yahoo.com.

the end of 2011. This was a noticeable violation, and you need to find out whether other signals stayed positive to tell you this was a "buy on weakness" opportunity. If the fundamentally oriented portfolio managers were convinced the growth story was still intact, they would be buying any pullback to the 200-day. Once again, price recovered from the violation of the 200-day and bounced higher.

Now let's look at the other technical signals on the weekly (Exhibit 7.2). Looking to the extreme right of the chart in Exhibit 7.2, in June 2012 you can see strong supply taking price down. See the big red spike in volume confirming that the drop in price is accompanied by significant selling volume. This is a serious selling cycle. The percentage price oscillator (PPO) line turned down as price topped out at $81, and price is now at $66 on the chart. The PPO histogram shows the bars below the line and peaking in a sell cycle. At the bottom of the chart, relative strength already broke below the 20-week exponential moving average (EMA 20) uptrend, giving a "heads up" that price may do the same and break below the 200-day. The strong uptrend in the 40-week (200-day) is saying "buy on weakness" provided there are no serious sell signals as a result of this pullback in price. The stock is trading at an 18 percent discount to the recent high. That 18 percent drop has already triggered some investors' sell discipline.

In Exhibit 7.3, prices broke below the 10-week (50-day) moving average, another indication of serious supply and the 10-week line turned down. Price is heading down to test the 40-week moving average in a

EXHIBIT 7.2 LULU, June 11, 2012, Weekly
Source: StockCharts.com.

deepening short-term sell cycle. On-balance volume (OBV) and accumulation/distribution have strong uptrends, but the supply is turning these signals down. There are no sell signals here yet. However, the Chaikin Money Flow (CMF) is still positive and in the green but has dropped very sharply down to the horizontal line, a sure sign of increasing supply you see taking price down.

There are two types of selling that drop price back to the 200-day to test the support in the long-term uptrend. First, the selling may occur because short-term the stock is overvalued, but long-term it is still a buy and the growth forecasts are robust. This type of selling may violate the 200-day briefly and then start moving up again when it is more reasonably valued. The second type of selling is because the overvaluation is long term, and decreasing growth cannot be corrected easily. Once a portfolio manager realizes that the stock is overvalued and the forecast for the future is dismal long term, he will sell out his position.

If more and more portfolio managers decide to sell for the same reasons, price will drop below the 200-day and stay below. This type of selling by more and more portfolio managers creates the sell signals and eventually confirmation of the sell signals. They are all reading the same fundamental research from the Wall Street sell side, namely brokers' analysts and their sales traders.

EXHIBIT 7.3 LULU, June 11, 2012, Weekly
Source: StockCharts.com.

CASE STUDY: LULULEMON BEFORE EARNINGS ARE REPORTED

It is Thursday, September 6, 2012, and Lululemon will announce earnings before the open on Friday, September 7. It is after 4 P.M. and the market is closed. Lululemon is in your aggressive growth portfolio and you have to be ready to make a very hard decision after the earnings tomorrow. If the earnings are good and price goes up, will you continue to hold it or will you sell into strength? If the earnings are bad, will you sell into the weakness in price as soon as the market opens? Or will you just ride out the selloff, and wait until next quarter to make your decision, hoping that the seasonally strong holiday season will reaffirm the growth and uptrend in prices?

The most important signal for the portfolio manager, relative strength (LULU: $SPX) at the bottom of the weekly Exhibit 7.4 just turned positive

EXHIBIT 7.4 LULU, September 6, 2012, Weekly
Source: StockCharts.com.

again. Lululemon has been an underperformer since May, doing worse than the Standard & Poors (S&P) 500 Index. An aggressive growth portfolio manager would be using a different index as a benchmark, but we will use this because it is readily available on the charting service. All the other signals on the chart are positive and moving up. Notice that price has moved up nicely for the past five weeks, correcting the sell signal created when it dropped below the 200-day moving average. The lagging, death cross, sell signal is still in place, and you can see it on the chart. The 50-day, 10-week, moving average is below the 200-day, 40-week, moving average. It has turned up, and if the earnings are good, this sell signal will be corrected. The 10-week will break above the 40-week for a lagging buy signal.

On the last pullback, seen in Exhibit 7.4, price did the same thing. It broke below the 200-day, put the death cross signal in place, and started underperforming the S&P 500. It successfully reversed these three sell signals last time. Will it do the same after earnings are announced tomorrow? You can see how crucial these earnings are.

If the earnings are bad, the chart will show confirmed sell signals that will take price from $68.60 today down to retest the recent bottom at $55. If the earnings report is good, there will be some selling on the news and price will pull back to retest the 200-day uptrend at $65. If the report is fabulous, price will run up to test resistance at $74.

The fundamental analysts are evenly split, with 9 out of 18 having buys. In the past week, two analysts have upgraded earnings slightly and one downgraded, but all were near the analysts' mean target for earnings for the year. There were questions about Lululemon maintaining prices in the face of competition and a global slowdown. Its super-high valuation with a price-earnings ratio (PE) of 41 left little room for bad news or any kind of a miss on future growth. The mean analyst 12-month target was $80, and the high was $86—not much room for price to go higher right now unless there is a fabulous earnings report coming. The move up from $54 to $68 before earnings had already put some really good news into price.

WHAT ARE YOU READY TO DO?

Before looking at the answer, take the time to map out what you are prepared to do after the earnings report comes out. Will you ignore another violation of the 200-day uptrend if the earnings are bad, or will you take this as a confirming sell signal and sell? Or will you wait for analyst downgrades to sell? If the report is good, reversing the sell signals, will you buy for the move up to retest the top and possibly put a new high in place? Or is it too late to buy? Make your decision now.

ANSWER TO THE CASE STUDY

The earnings report was good, and the stock added on another 12 percent. The total move up in just the past five weeks was an eye-popping 40 percent. Portfolio managers would be happy to do that in a year. Those portfolio managers who held on despite the sell signals in the 200-day moving average and in relative strength were rewarded for their faith in fundamental analysis, despite the fact that only half of the fundamental analysts on Nasdaq.com had buy ratings on Lululemon.

There was only one technical signal in Exhibit 7.4 that would have kept the portfolio manager holding Lululemon, and that was the CMF at the top of the chart. Due to the Chaikin methodology, steady accumulation over 20 periods of time is weighted more heavily than recent, sudden, short, gap moves down in price. The 200-day moving average and the relative strength signal are driven by price.

It is possible that the price of Lululemon was manipulated or distorted by traders and short sellers; CMF obviously was not affected by this. It is possible that the flaw in Chaikin methodology was an advantage in the case of Lululemon. There was a large short position in Lululemon before earnings, and the 12 percent move up on a good, but unspectacular, earnings report looked very much like short covering or panic buying.

Here was my answer to the case study, titled "Lululemon Targets Old High," published on Marketwatch.com the day earnings were announced for Lululemon on September 7, 2012, at 3:34 P.M.:

> *Lululemon (LULU) had a good earnings report, rocketed up almost 10% and is reaching for its old high at 81. This is remarkable since it had already moved up over 30% since the beginning of August while looking forward to earnings. More than 25% of the float was short or about 8 days of average trading. Hard to believe there were still shorts to squeeze after the 30% run-up in August. Today's price movement cannot be explained just by earnings. Shorts are usually smarter than this.*
>
> *This is the third time that LULU has given a false sell signal by breaking below the 200-day moving average and then reversing itself on the weekly chart. It is not that unusual for price to violate the 200-day and then recover. The real sell signal comes when the reversal move above the 200-day quickly fails and goes back below the 200-day and stays there. That really puts the portfolio managers' fingers on the trigger to sell.*
>
> *The enormous move up and the clearly overextended price jumps out at you from the point-and-figure chart. You can also see on this*

chart the resistance at 76-78 that will probably stop this move up. Price is not going straight up to 81 without a little give back after the shorts have covered.

According to the point-and-figure chart that push back could be down to support at 71-73 from today's high of just under 76. A major market pullback might even take LULU lower before its next attempt at 81. A major move up from a possible QE3 would make the attempt at 81 sooner.

The valuation grid at StockpickerUSA.com has it in Box 7, which is overvalued and overbought technically, as of last Friday. The score adjusted (adj) for the growth stock universe is good at 9 vs. the worst score of 30 and the best score of 3. Our analyst model did not pick up any improvement before earnings, but the earnings forecast model was good, and StockpickerUSA.com had it rated as a buy.

At Nasdaq.com, nine analysts out of 18 had buys, and their mean 12-month target was 80, with the high at 86. There were a couple of analyst upgrades in earnings just before the report, but only slightly above the mean earnings of 1.62 for 2013. The forecasted PE (FPE) of 42 for 2013 earnings vs. the industry FPE of 24 reflects the aggressive growth expected from LULU. That high FPE attracts the shorts.

Looks like the shorts were wrong once again, and LULU continues to fool the market and surprise with its continued growth in the face of lower-priced competition and a global slowdown. Their high margins are dropping slightly, and that may continue if they sacrifice margin for revenue growth and continue to grow inventories.

For now, LULU has once again re-affirmed its growth and continued the uptrend in the 200-day moving average as well as its outperformer status vs. the S&P 500 index

Exhibit 7.5 is the Point & Figure chart mentioned in my article showing how over-bought it was before earnings. Look at the latest column of X's on the right going up from $54 to $77 without any pullback.

NOW ARE YOU READY TO SELL CALL OPTIONS?

You are now convinced that you will continue to hold Lululemon in your portfolio. You are also convinced that, based on the more than 40 percent move up in price in a very short time, price is probably overextended or overbought. Price is close to the 12-month mean target. After the good

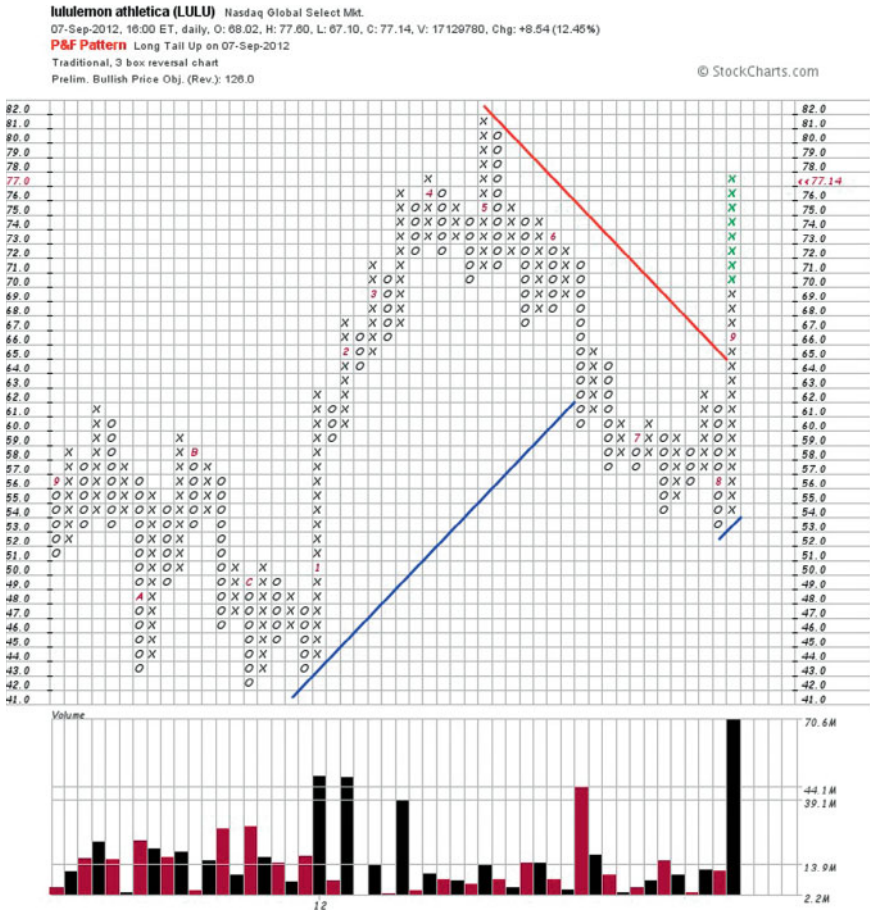

EXHIBIT 7.5 LULU, September 7, 2012, Point & Figure
Source: StockCharts.com.

news in earnings and the 10 percent pop after earnings, the market is probably inefficiently priced at these levels. Short covering probably accounted for some of the move up. Now that the shorts are covered and price is overextended, it probably is a fairly safe time to sell call options against the stock in your portfolio. If you expect the price to drop then the call options you sold will expire worthless and you keep the money you received when you sold the call options. You could also use the money you receive for selling the call options to buy put options since you now expect the price to go down. Basically, you are buying protection for the move down in Lululemon at no cost. If price goes down significantly, your loss is covered by the puts.

By selling the call option and receiving the price for the option, you are at risk. If the price goes above the strike price, that is, the stipulated price of the option you sold, then your stock will be called away from you and you will receive that strike price for your shares. For example, if you have 500 shares of Lululemon in your portfolio and you sell five call contracts for the $85 strike price, then if the price goes to $86, your shares will be called away from you at the $85 price. You won't be that upset because you never thought it would go to $85, and at $85 you may be a happy seller. Each option contract is for 100 shares, thus five contracts is the equivalent of 500 shares. If the stock does not go above $85, the options expire worthless and you keep the price you sold them for, which may have been $2 per share. In this example, you made $1,000 for selling the call option for $2 each for your 500 shares.

Now let's look at Exhibit 7.5. The last high on this chart was $81, which means price failed to reach $82. You can see at the top of the Point & Figure chart that a column of X's reaches to $81, seen on the right and left scales of price. Notice the drop from that high. If you had sold the $85 calls for $1, then you made $500 dollars because price never reached $85 and the options would have expired worthless. Of course, you had a significant paper loss in the value of your stock, but you had already decided to hold for the long term.

Now let's look at Exhibit 7.6 dated October 8, 2012, to see how we would set up the selling of call options based on the latest price of the stock and the actual price being quoted for the call option. At the top of Exhibit 7.6, we will use the overbought oscillators, RSI and stochastic, plus the momentum oscillator, the MACD. These are the popular signals. However, we will also show the MFI, the parabolic SAR, and the directional with ADX just for a little more color in how to time the sale of the call options. The weekly chart is used because it is a strategic decision rather than tactical as to when to sell the call option. Let's look at the signals to see the timing.

Looking at the signals above the price in Exhibit 7.6, you can see that the stochastic is above 80 on the scale shown on the right edge of the chart, in the overbought territory. It's at 84.86. It can stay overbought for some time, as you see by checking how long it stayed overbought the last time. Therefore, you may want to wait for this signal to turn down. The RSI overbought signal is not flashing yet as the RSI continues to move up, but is still below the 70 marker on the scale. It's only at 60.52. You may want to wait for that to turn down before selling the call option because you want the options to expire worthless. Finally, the MACD line is still headed up and has not turned down. The histogram bars likewise have not started to drop to the horizontal. All these signals have you in "wait mode" to sell the call options.

EXHIBIT 7.6 LULU, October 8, 2012, Weekly
Source: StockCharts.com.

They reflect what you can see in the candlesticks. Price seems to want to retest resistance, and it still has not reached the old high of $81. Price did pull back from $79 to $74 and then went back up again, but only to $76, not $79. Notice the pivot point, resistance labeled R2 on the price chart at $79, just where price was stopped. Also look at the upper band of the Keltner channels, holding price in check at $79 but the upper channel line is rising to higher prices.

The price pattern is one of higher highs and higher lows, and if that pattern is followed, then price is trying to put a higher high in place at $82 or above. The question is: when will this move up run out of steam and at what price? What is a safe call option price to sell that will earn some money?

On October 8, the November $85 calls were selling at $1.80. This option expires on November 15, the third Friday of the month. If you wait for the signals to turn down and price goes up to $83 before topping out, then you will sell it for more than $1.80, perhaps over $2. If price stays below $85 on option expiration on the third Friday of November, you will pocket $1,000 on the five contracts you sold at $2 if they expire worthless. In addition to the popular signals RSI, MACD, and stochastic, let's look at the other signals to see if they have any added value.

I find the parabolic SAR very helpful as a lagging indicator because when this signal changes it is already late. You will sell the options now with lower risk and lower return because the option price has fallen. These dots are following a trend determined by ever tightening exponential moving averages (EMAs). In Exhibit 7.6, in August and September 2012 you see that price has moved up to $79 and the dots moved up under price. As price moves up, the dots move closer to price and eventually price breaks below, and then the dots switch to above price and start tracking the downtrend. So this signal would prevent you from selling the calls too early. It will provide a late signal for selling the calls. In this case, with price trying to put a new high in place and all the other signals still pointed up, a late signal may be better than an early signal. If nothing else, the parabolic SAR is a reminder to decrease risk by waiting to sell signals. Don't sell those call options too early because you want them to expire worthless.

The signals at the bottom of Exhibit 7.6 are also moving up and suggesting that you wait to sell the call options. If you check what these signals did on the last pullback from $81 to $54, you will know what to do. When they turn down it is time to sell the calls because you are looking for lower prices to ensure that the calls you sell are out-of-the-money, worthless options by the third Friday of November. Don't forget you don't need price to go down very much because you only want price to be just below $85 the price of the options sold.

Selling (writing) covered call options, as this is called, is very popular with portfolio managers. How any portfolio manager can do this using fundamental analysis is completely beyond me. Technical analysis signals provide the necessary assistance and guidance to selling covered calls. Whether the price of Lululemon ever reaches $85 by options expiration depends solely on supply and demand, not on fundamentals. All the fundamentals are already known. Supply and demand measured by technical analysis will determine where price goes.

All technical signals measure supply and demand. They help to enhance exactly what you are seeing on the candlestick chart in terms of price and volume. Price and volume will determine demand and whether price reaches $85. Right now, in Exhibit 7.6, you can see the signs of weakness after price had a 48 percent run-up from $54. The move up on the chart is tiring as buyers are exhausted. Price is being stopped at $79 to $80. It can't seem to put the new high in place. The technical signals show that the stock is overbought and ready for a pullback. But the signals have not turned down yet. These signals helped you not to be fooled by the first pullback from $79 to $74 in September 2012. When these signals turn down, you will know it is time to sell the calls on Lululemon.

Not only do traders have to use technical analysis, but also any portfolio managers writing covered calls on their portfolio of stocks must use technical analysis because fundamentals will not provide the signals needed to write covered calls. Only technical analysis will do this for the portfolio manager.

FALSE SELL SIGNALS IN THE 200-DAY AND RELATIVE STRENGTH

Lululemon is a good example of false sell signals in the 200-day moving average and in performance relative strength. These two signals are the most important for the long-term investor and portfolio manager. As we have indicated, a sell signal does not mean "sell right now," especially for a portfolio manager. A sell signal in these two long-term indicators means that the portfolio manager must put the stock on a "sell watch list." What is that? It is management by exception, and stocks flashing these long-term sell signals have just become exceptions for the portfolio manager requiring the utmost attention if the portfolio manager hopes to beat the index. It requires the portfolio manager to move past any fundamental bias and find out why the sell signal is in place. Remember Enron and the fundamental analysts who were recommending buys when it was already in a technical analysis death spiral. That will quickly move you away from any fundamental bias.

What is the portfolio manager to do once these sell signals have appeared for a stock such as Lululemon? To see these sell signals on the chart, simply go back to Exhibit 7.4 and notice the false sell signals as price breaks below the 200-day moving average in December 2011 and July 2012. What is the rule for the portfolio manager to follow when he sees these sell signals? Wait for confirmation. Also notice that other signals in Exhibit 7.4 in September 2012 are encouraging the portfolio manager to wait for confirmation. The CMF is still looking positive and there is no strong breakdown in red below the line. There is a lack of continued supply supporting this false sell signal. Also, OBV has not yet changed to a downtrend confirming this sell signal. The portfolio manager is waiting for one of three things to happen:

- Price will continue down, confirming the sell signal and breaking support levels, and the portfolio manager will sell on this confirmation.
- Price will turn up, stay above the 200-day, and correct the sell signal, in which case the stock will not be sold. This is what happens to Lululemon.
- Price will form a bull trap, a fake-out move to the upside going above the 200-day and then dropping below it again on increasing volume, thus flashing a confirmed sell signal.

The confirmation procedure for avoiding false sell signals such as the violation of the 200-day moving average is to wait for the top of the next buy cycle indicated by the MACD or PPO. If price fails to correct the sell signal at the top of a buy cycle, the portfolio manager can sell into the strength at the top of the MACD buying cycle, when the bars of this histogram are peaking above the horizontal.

All of the preceding also applies to the violation of the performance relative strength signals. As can be seen in Exhibit 7.4, at the very bottom of the chart is the performance relative strength (LULU: $SPX). You can see that it violates the uptrend line, just like the violation of the 200-day moving average above it. You can also see that it reverses these two false signals.

If you look at Exhibit 7.4, dated September 6, 2012, you will see the peak of the selling cycle in July for Lululemon. You expect selloffs to trigger sell signals just as you expect buying cycles to reverse sell signals. When the buy cycle fails to reverse sell signals, you have a confirmed sell. Because this confirmation occurs at the top of the buy cycle, the portfolio manager can sell into strength instead of selling on weakness.

By looking at Exhibit 7.4 you can see the peak of the selling cycle in July 2012 at $53.79. Look at the MACD signal; all the bars are peaking

below the line to identify the peak of this sell cycle for you. Now follow these bar lines as they move above the horizontal and peak to the upside in a buying cycle. You can see that the buy cycle peak on October 8, 2012 (Exhibit 7.6) has corrected the sell signals, in particular relative strength (LULU: $SPX). This is exactly what you want to see, confirming that the sell signal is reversed and Lululemon is removed from the sell watch list. If the sell signals were not corrected at the peak of the buy cycle in September 2012, then the portfolio manager would have confirmation of the sell signal and would be able to sell into the strength of the peak of a buy cycle.

Again looking at Exhibit 7.6, you can see that the stochastic signal does the same for you. In July it is deeply oversold, identifying the peak of the sell cycle and in agreement with the MACD. This means that two different signals, one a momentum oscillator and the other an overbought/oversold oscillator, are in agreement. In technical analysis you want to have different signals confirming each other, rather than similar signals. For example, the MFI, RSI, and stochastic are overbought/oversold oscillators, and you would expect them to agree. This is not true with the MACD, which is a momentum oscillator. When these two signals, the MACD and the stochastic, agree, you have different types of signals confirming buy cycles and sell cycles, giving more reliability to the conclusion.

Both the MACD and the stochastic identify the top of the next buy cycle for you in September 2012. As you look down the chart, you see that the demand was so great during the buy cycle that it corrected and reversed the sell signals. It is not good enough just to recognize buy and sell signals. The portfolio manager needs confirmation of these signals before he commits to buying or selling millions of shares.

Exhibit 7.6 also has another important signal encouraging the portfolio manager to wait for confirmation of the sell signal because it will probably reverse itself during the next buy cycle. At the peak of the July 2012 sell cycle, look just below price for the "P" line at $47.93. This is the pivot point line and an important guideline for any buy or sell signal. If price breaks below this line, you have an important negative signal. Notice, however, in the case of Lululemon that the worst of the selloff in July 2012 could not get price below the P line even though it did trigger sell signals in the 200-day moving average and relative strength shown in Exhibit 7.4. This positive signal was a leading indicator that the sell signals would be reversed. Technical analysis is all about finding reliable leading indicators. In this instance, the pivot point and CMF were leading indicators of a positive reversal of the sell signals. Unfortunately, these do not always work as leading indicators.

SUMMARY

In this chapter, popular technical analysis signals such as RSI, stochastic, and MACD were used to correctly time the selling of covered call options and buying puts. Other less known signals such as pivot point and CMF, as well as older signals such as performance relative strength, OBV, parabolic SAR, and MFI were also used, as well as accumulation/distribution and PPO. The key to avoiding false sell signals in the 200-day moving average is detailed in the procedure for confirming sell signals before acting.

Successful Stock Signals for Traders and Portfolio Managers: Integrating Technical Analysis with Fundamentals to Improve Performance, Thomas K. Lloyd, Sr.

CHAPTER 8

Blow-Off Top, Trend Line Reversal, Channel Breakout, and Fan Lines, with Green Mountain Coffee Exhibits

WHY STUDY STOCKS THAT BLOW UP?

In the case of Herbalife (HLF) in Chapter 4, Green Mountain Coffee (GMCR) in this chapter, and Netflix (NFLX) in the next chapter, you will notice we are spending an inordinate amount of time on identifying sell signals for stocks that blow up. That is because these are negative surprises. One of the foremost reasons that professional portfolio managers fail to beat the index is the negative surprise that destroys their portfolio performance. Portfolio managers would give their right arm for technical signals that could help them see disasters like this forming. There are usually no confirmed sell signals, but there are sell signals to set the warning bells off because the market usually knows bad news before it is announced in the media. Traders front run the news, and it shows up on the chart as buy signals or sell signals.

Those professionals with illegal inside information or legal, very insightful information will trade, and technical analysis will spot those trades, especially if done by institutions in large trading volume. "First calls" by Wall Street brokerage analysts to institutional clients will usually appear on the chart as institutional portfolio managers start transacting in size. This

is the demand that turns sell signals into buy signals. If you are not on the first-call list because you don't pay enough for research, then you need to know and use technical analysis.

HOW TO MAKE MONEY WHEN A STOCK CRASHES

Selling a stock short means you borrow stock from your broker, much the way you would borrow money from a banker. You borrow the stock so that you can sell it because you believe the price of the stock is going down. If it does go down, say from $100 to $50, you have made 50 points because you sold the stock at $100 and bought it at $50 to "cover" the stock you borrowed. After you buy the stock at $50, you can't keep it because you have a loan to pay back. Your broker takes the stock and gives it back to those from whom you borrowed it. However, hedge funds have a big advantage over the small trader when it comes to selling short. The cash balance created in the account by selling borrowed shares will sometimes receive interest for the hedge fund cash balance but not for the small trader. This additional income is important when interest rates are high.

Hedge funds buy and sell stock short, while your typical mutual fund will usually only be able to go long, that is, buy the stock first and then sell it. Shorts in hedge funds do just the opposite; they sell first and then buy it back at lower prices to make their money. David Einhorn runs a hedge fund. He could make money by short selling the stock of Green Mountain if he expected the price to go down based on his analysis of the company. Releasing his brilliant research to the public greatly accelerated the drop in price. In Exhibit 8.1, you will see the dramatic drop in Green Mountain price, after David Einhorn delivered a presentation at a conference showing the weaknesses of Green Mountain. One key weakness was the patent expiration of Green Mountain's K-cup technology, thus eliminating the Green Mountain patent monopoly.

BLOW-OFF TOP AND TREND REVERSAL

As you can see on the 5-year (Exhibit 8.1), Green Mountain was in a nice long-term uptrend. You can see the significant increase in the slope, the upward angle of the 200-day moving average, the green line during 2011, which indicated increased price momentum to the upside. Price peaks at above $100 in a blow-off top, stretched far above the mean, or the 200-day average; then price crashes going down through the 200-day uptrend and stopping just above $40. In addition to the violation of the 200-day, you

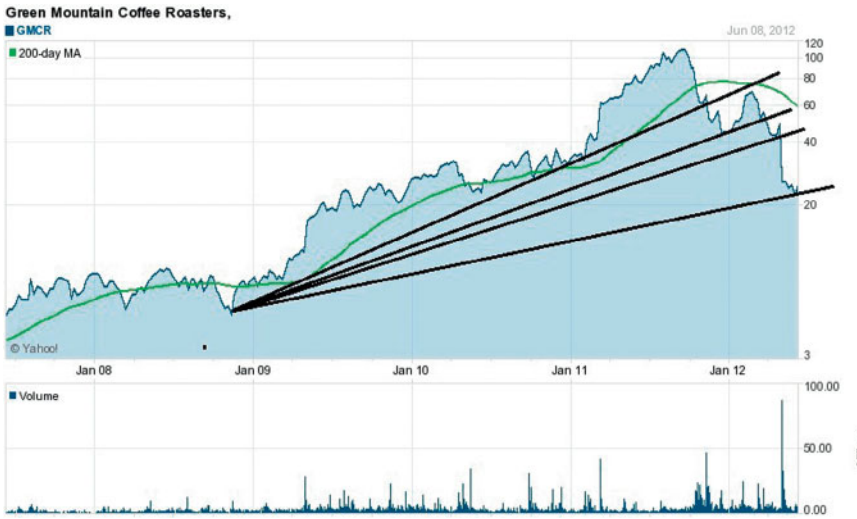

EXHIBIT 8.1 GMCR, June 8, 2012, 5-Year
Source: Yahoo.com.

can see price violating uptrend lines that form a "fan" pattern on the chart. After the violation of the 200-day line in green, each violation of the black fan lines is a confirming sell signal. The uptrend fan lines are drawn by connecting the bottoms reached by price. The dropping fan lines and the violation of the fan lines by price are the signs of price in a downward spiral looking for a bottom.

Then the dead cat bounce takes Green Mountain back above $60 in 2012 on Exhibit 8.1, but price fails to even reach the 200-day moving average in green and price turns down again for a confirmed sell signal. This is confirmation of the original sell signal and a signal that you must sell into the strength of this bounce up. Price drops from above $60 to just above $20.

Now you need to look at Exhibit 8.2 to see more clearly the technical analysis signals that preceded the fall of Green Mountain and the more accurate price levels than those shown in Exhibit 8.1.

SELL SIGNALS BEFORE THE FALL

The Chaikin Money Flow (CMF) in Exhibit 8.2 caught the selling at the price top of $111 in August 2011 going deeply into the red. This supply takes price down to violate the 50-day red line on the chart for another sell signal. This

EXHIBIT 8.2 GMCR, June 11, 2012, Daily
Source: StockCharts.com.

is followed by yet another sell signal; there is a double-top formation at $111 and $115 in August and September 2011, this bearish signal is known by every portfolio manager; there is no secret here. The double top is confirmed when price breaks below the 50-day moving average again in September and fails to correct that sell signal when price bounces back up to $96.77 in early October. Price fails to reverse the sell signal because it fails to move above the 50-day red line on the chart in Exhibit 8.2. Instead, price drops sharply lower, breaking an important support level at $83 for another sell signal.

In between the formation of the double top, you can see that price breaks below the 50-day uptrend in August 2011 for a sell signal. The double-top formation after this sell signal was the second warning that Green Mountain was in trouble. This is a warning for the portfolio manager to call all his analysts and verify the fundamental story and determine what is causing the sell signals. If the portfolio manager is not using technical analysis, the warning will be ignored and the negative surprise will indeed be a surprise when it eventually unfolds.

As Exhibit 8.3 shows more clearly, the confirming sell signal appears in late September 2011 as the price breaks sharply below the 50-day to $94 confirmed by a negative relative strength signal and directional movement. With the confirmed sell signal in place, every portfolio manager using a technical analysis sell discipline is using the bounce up to $97 in early October 2011 to sell into price strength. Those portfolio managers who did not have this sell discipline of selling into any bounce up after the confirmation of

EXHIBIT 8.3 GMCR, November 1, 2011, Daily
Source: StockCharts.com.

the first sell signals saw price drop to $34 in November 2011. They had to sell into weakness all the way down from $97 to $34. Meanwhile, all those traders and hedge funds who sold short at $97 and bought back or covered at $34 had realized a fabulous 63-point profit on a 65 percent drop in price.

SELLING SHORT AFTER EINHORN'S PRESENTATION

Selling short at $84 the day after Einhorn's presentation of the fundamental flaws in the Green Mountain story proved very profitable for the traders and the hedge funds, as it went to $34 for a 50-point profit. It turned out to be a disaster for the mutual fund portfolio managers who could not quickly unload stock. The small investors who owned Green Mountain because they loved their K-cup coffee and Keurig coffee maker could not believe the drop in price and probably held it all the way down. They had no iron-clad technical sell discipline.

There is a problem with owning a company that is making a great product that you like, if someone puts a needle to the balloon in price. In this case, Mr. Einhorn published the fatal fundamental flaws for the future of the company. Portfolio managers dumped the stock when they heard his case presentation. Mr. Einhorn apparently did a better job of fundamental analysis than most of the sell-side brokerage analysts and buy-side portfolio managers and their own buy-side analysts. In this case, the fundamentals were the primary movers for creating supply that took price down. The Einhorn presentation of the fundamental weaknesses created the supply that moved price because it prompted portfolio managers into panic selling.

There is no question that fundamentals and a new, insightful analysis of fundamentals can create enormous supply or demand that will move price dramatically. It will prompt portfolio managers and traders to buy and sell in size, sharply moving price up or down. There were plenty of opportunities to follow Einhorn's lead and make money as the price of Green Mountain fell. In fact, the selling started before Einhorn's presentation.

On September 29, 2011, well before Einhorn's October 17, 2011, presentation on Green Mountain, price shows a big drop in price from $106 to $96, as shown in Exhibit 8.3. This is an unusually large red candlestick if you look at the previous candlesticks. Volume is more than average and price actually goes as low as $91.50 before bouncing back to the $96 close. The large bounce up from the price low of the day could be a sign of short selling. After the shorts are finished, selling price will return to the mean if no news is announced. Market makers will immediately start buying after the seller is finished, as will the pilot fish day traders swimming by their side as they play the bounce.

Looking at all the daily signals in Exhibit 8.3, you will see nothing but weakness. The CMF in red and green and the MACD bars in blue at the top of the chart are dropping on October 1. The Keltner channel surrounding price has turned down in a bearish trend. Price has broken below the 50-day moving average. MFI, OBV, and accumulation/distribution at the bottom of the chart are heading down, all signs of supply that will take price lower. Relative strength (GMCR: $SPX) breaks down, forming a sell signal in the last week of September.

At the very bottom of Exhibit 8.3 is the deadly crossover of the minus D1, a red line, going above the plus D1, a green line, on September 24, 2011, weeks before October 17. The dark black line in directional movement starts rising in the first two weeks of October; this indicates that the falling price is a big move. There were big sellers well ahead of Einhorn's presentation that was done on October 17. Price had dropped from $105 on September 29, 2011, to a low of $82.40 on October 4, for a 22 percent drop in price. On the day of Einhorn's presentation, price drops from a high of $91.92 to a low of $79.33 and closes at $82.50—almost exactly the low of September 29. As you can see from Exhibit 8.3, price continues lower after October 17, putting in two more sell signals as it breaks below the 200-day moving average at $75 and the pivot point (P) on the right-hand scale, at $72. There is enormous volume confirming the 10 sell signals showing in Exhibit 8.3.

All of these sell signals with the exception of the 200-day signal and the pivot point were in place before Einhorn made his presentation. This proves that you cannot hide impending bad news from the market if it is known by some professionals. Technical analysis will detect known negative information where professionals are trading on the information. Einhorn's brilliant research demands and receives high rewards on Wall Street. The only thing you can say for sure is there was so much selling before Einhorn's presentation that it triggered nine of the technical signals in Exhibits 8.2 and 8.3. Who knew what and when? There were sell signals before Einhorn's presentation. Using technical analysis will help you swim with the sharks.

THE FATAL SELL SIGNALS

The technical analysis sell signals triggered before Einhorn's October 17 presentation were:

- Price breaks below the 50-day moving average.
- Price forms a double top.
- The 20-day breaks the 50-day moving average in a downtrend.
- The CMF goes into the red below the line.

- Plus D1 in green and minus D1 in red do a negative crossover on directional movement. The red line goes above and green crosses below.
- The average directional movement index (ADX) dark line on directional movement trends up as price drops.
- The Keltner channel reverses from uptrend to downtrend.
- Price violates the mean dotted line of the Keltner channel.
- Performance relative strength reverses to a downtrend underperformer.

The weight of evidence in these technical signals was overwhelming and indicated that something was happening to Green Mountain before October 17 that was not good. For the portfolio manager the most telling of the red flags was that Green Mountain was underperforming the S&P 500 Index and the trend was down in relative strength (GMCR: $SPX). Every stock with this profile has to be on the portfolio manager's watch list of stocks that require his or her immediate attention.

This identifies the exceptions in any portfolio that require portfolio management action if the manager hopes to beat the index or the portfolio benchmark. Technical signals by their nature are late, so there is no time to procrastinate in finding out what is wrong with Green Mountain before the sell signal hits on October 17. The smart money knew. If you can't afford to pay the money to be as smart as the insiders on Wall Street, then you better learn technical analysis and have a technical analysis sell discipline as an arrow in your quiver to use and protect your portfolio.

BOTTOM FISHING GREEN MOUNTAIN A YEAR LATER

A year after the negative surprise in Green Mountain, as shown in Exhibit 8.4, it is still bottoming and some folks are thinking about the possibility of buying a bargain. The same hedge fund manager is still negative on this stock. If he is greedy, he may still be short the stock. The shorts can afford to wait for the first signs of life in the stock price before covering. The bargain hunters, however, want to accumulate at the lowest possible price and don't want their buying to be detected. They certainly have no incentive to drive up the price and tip off the shorts before they accumulate a full position. Let's see if you can detect any bottom fishing buying in Exhibit 8.4, but before doing that, let's examine some of the fundamental aspects to see if these are appearing on the chart.

I like to use Nasdaq.com because they have a great variety of information available on stocks. I encourage you to explore this website and you will be amazed with the analytics. I especially like to see which institutions are buying and selling the stock. Here, I have the advantage of

EXHIBIT 8.4 GMCR, October 17, 2012, Weekly
Source: StockCharts.com.

knowing where the smart money is, but you can quickly learn which firms are the smart investors and which are not. After each big negative surprise in any stock, check the institutions that held it. Likewise, after each really great positive surprise, do the same. Within a few months you will know where the smart money is. Don't forget the largest money managers have the most money to buy the best research. The portfolio managers with the highest turnover rates (i.e., they buy and sell rather than buy and hold stocks) have the most money for research, and these are usually hedge funds. They may have a tough time making performance with high turnover but they will probably have the best research on the best stocks.

On October 17, 2012, the date of Exhibit 8.4, Nasdaq.com was reporting the following: Green Mountain was a weak buy, according to the 14 analysts with recommendations. Only 7 of 14 analysts had it as a buy, and this information was provided to Nasdaq.com by Zacks Investment Research. In the news, Starbucks is out with their coffee maker. Kraft is making K-cups for its Maxwell House coffee. Dunkin Donuts is selling K-cups in their stores. Green Mountain announced an agreement with Snapple for teas. Other coffee-making machines are coming out now that K-cups are off patent.

Green Mountain is losing business to these competitors, and it is unknown what amount of business will be left for Green Mountain now that there are other coffee machines and other companies producing coffee in K-cups. Green Mountain now needs to produce K-cups with exclusive coffee brands nobody else has, and it needs more exclusive Snapple-type agreements. It is now in competition with the brand coffee names that are producing their own K-cups. Like Research In Motion, Green Mountain is down to its core of loyal customers, and it remains to be seen whether it will survive in such a competitive business. Both of these companies have a corporate culture that grew up with a patent monopoly. Can such corporate cultures make the switch to a very competitive environment? Can they survive and become profitable? These are unknowns, and the market hates unknowns. The market loves patent monopolies, which are certain about the future.

The bottom fishers and bargain hunters are betting the core business will survive and be profitable. Further, they believe the stock is oversold and undervalued. Meanwhile, on the first anniversary of his famous presentation, Einhorn has reiterated that Green Mountain is still a short. Unless Green Mountain comes up with some miracle coffee, he may be right. The price of Green Mountain recently popped up on the news it was going international. Without any buy signals showing on the current chart, traders will sell short every pop up in price on the latest news of hope for the future.

Now let's turn to Exhibit 8.4 to see if Einhorn is right. As you can see, the portfolio manager looking at this chart has yet to see a buy signal for the long term. This is a weekly chart used for strategy, not tactics. The portfolio manager wants to see buy signals surviving any pullback so that he now has a confirmed buy signal and can buy on weakness.

LOOKING FOR BUY SIGNALS

In Exhibit 8.4, you do not have this buy signal profile. As a matter of fact, even when the MFI was approaching overbought at $33 after a nice bounce up from the bottom, there were no long-term buy signals triggered at the

peak of the buying cycle when you expect to see such signals. Now as price retests the bottom, trying to put a double bottom in place, you certainly won't see any buy signals. Buy signals in this case will be when price breaks above the Keltner channel. As you can see, it did not even come close to doing this on the bounce up to $33. Likewise, performance relative strength (GMCR: $SPX) failed to positively breakout above the 20-week exponential moving average (EMA). The trend of the average is no longer down but going sideways, and that's some improvement. You want to see a breakout above the 20-week EMA line, and you want to see this line move to an uptrend.

Portfolio managers are looking for a reliable buy signal that will not reverse itself. A breakout above the Keltner channel and a change in relative performance to an uptrend improves the reliability of the buy signals. Once these buy signals are in place, the portfolio manager will wait for the next pullback in price. This gives him two very important benefits: it enables him to buy on weakness and to make sure the buy signal is confirmed; that is, the buy signal survives the pullback in price. This approach adds enormous reliability to the buy signal. The last thing a portfolio manager wants to do is buy a stock in size and then quickly sell it because the buy signals reversed to sell signals again.

Bottom fishing is very "dicey." The portfolio manager wants to assure himself that Green Mountain does have a confirmed bottom in place at $17 and it is not going any lower. Further, he wants to know that price is not going to be stuck on the bottom for an extended period of time. The portfolio manager wants to buy as cheaply as possible just before price starts its move up and starts outperforming the market once again. Thus, the portfolio manager needs very reliable and accurate signals.

To achieve this objective, the portfolio manager must look at long-term charts and long-term signals that provide good timing and excellent reliability. In most cases, timing will be sacrificed for more reliability so that reversals in signals are avoided at all costs. All portfolio managers will use fundamentals to make a bottom-fishing decision. To avoid the value traps, portfolio managers need to use technical analysis.

The problem with Green Mountain is the same problem for Research In Motion, Herbalife, Hewlett-Packard, Facebook, and Netflix. The basic business model is in question. The market hates unknowns, and there are too many unknowns about how these companies will operate and survive going forward. Einhorn has indicated that Green Mountain is a continuing short in October 2012, Chipotle Mexican Grill is a short, and there are questions about Herbalife. If a portfolio manager is going to bottom-fish Green Mountain, he has to be smarter than Einhorn.

TRADING THE DEAD CAT BOUNCE

You probably noticed in Exhibit 8.4 that if you traded the dead cat bounce from $17 to $33 from July to September 2012, you would have almost doubled your money. This type of trade is risky but very profitable for traders and hedge funds. Let's look at the short-term daily (Exhibit 8.5) and its buy signals to see if you could have traded some portion of this move up. Here, you are switching from long-term to short-term signals, and the strategy is just the opposite of the one outlined earlier for portfolio managers.

Traders are interested in good timing signals, and the reliability of signals is only secondary. Traders, by their very nature, will quickly reverse themselves if the signals are proven to be wrong. They expect reversals and handle them as a normal course of doing business. They know technical signals are not perfect, and they try to use information that leads technical signals. Traders are contrarians buying oversold signals and selling overbought. Unlike the portfolio managers, they are never embarrassed when they have to reverse a position quickly as it goes against them. "Traders cut their losses and let their profits run." They expect trades to move against them and are looking for the trades that will keep moving in the direction they want.

As long as the profitable trades are far more profitable than the losing trades, they are happy and they don't dwell on the losing trades. They just cut their losses quickly and go looking for the profitable trades that will make up for the losses and still give them a nice profit. Unlike the portfolio manager who can move the market price because of the size of his orders, the trader has no such worry. It is easier for a trader to sell a bad position at less of a loss than the portfolio manager.

Exhibit 8.5 identifies all of the trader's buy signals with blue arrows. The first and most important, the prime mover of all technical signals, is the gap-up in price during the first week of August 2012 on a big spike in volume. Directly under the big white candle confirming the gap-up buy signal is the parabolic SAR dots shown under price, a positive buy signal. This is really stunning because it is usually a lagging signal, but it is very timely here. Usually, this will be the beginning of 5 to 10 days of demand and rising prices. It usually does not reverse quickly. It gives a strong vote of confidence to the gap-up in price and big white candlestick buy signal supported by the volume spike. There really should be four blue buy arrows pointing at price, volume, candlestick, and parabolic buy signals.

Next are the popular signals with traders, namely, the RSI and stochastic; they turn up sharply from oversold. Traders like to catch the move up from oversold to overbought. The MACD histogram not only confirms as the bars move up but also has a leading indicator aspect. See how shallow

EXHIBIT 8.5 GMCR, October 17, 2012, Daily
Source: StockCharts.com.

the bars below the line are just before the bars turn up. You can compare this weak signal of supply at the very bottom in price to the previous strong signs of supply with deep bars below the line as price headed down to the bottom.

Signals not that important to the trader but supplying additional confirming signals are the Aroon oscillator, which is clearly a lagging indicator in Exhibit 8.5. An important piece of the puzzle is the performance relative strength (GMCR: $SPX) because it indicates that Green Mountain price is doing better than the market. Demand created by the market is one thing, but demand taking up price better than the market is a more significant signal. Finally, at the bottom of the chart is directional movement (ADX, plus D1 and minus D1). There is a dramatic signal crossover as the green plus D1 crosses to the upside and stays above the red minus D1. I like using this signal. The ADX dark line does not move up very strongly, indicating that this move up would not be that strong—hinting that this could top out and go back down to form a double bottom.

SUMMARY

This chapter highlighted nine sell signals warning portfolio managers before the October 17, 2011, presentation on Green Mountain Coffee by David Einhorn. The nine sell signals were the 20- and 50-day moving averages, the double top, CMF, relative strength, Keltner channels, directional movement plus D1 and minus D1, and ADX. The final 10th signal was the 200-day moving average sell signal after October 17.

In addition, 10 buy signals for traders were illustrated for Green Mountain's dead cat bounce up from the bottom of $17 to $33 for almost a double. These signals were MACD, candlestick, parabolic SAR, volume, directional movement plus D1 and minus D1 with ADX, relative strength, RSI, MFI, stochastic, and Aroon oscillator.

Successful Stock Signals for Traders and Portfolio Managers: Integrating Technical Analysis with Fundamentals to Improve Performance, Thomas K. Lloyd, Sr.

CHAPTER 9

Classic Top, Death Cross, Double Bottom, Bull Trap, and Dead Cat Bounce, with Netflix Exhibits

CLASSIC TOP: END OF A LONG-TERM UPTREND

Netflix shows the classic top, rolling over after a long run up to above $300 in Exhibit 9.1. Then like dominoes falling, the technical sell signals warn of impending disaster and a drop to $62. First, the short-term signals fall, the on-balance volume (OBV), stochastic, and MACD. OBV, leading the other indicators in Exhibit 9.1, had flattened out in a top formation for many weeks. Next appear the violations of the 20- and 50-day moving averages in Exhibit 9.1 and the 200-day moving average in Exhibit 9.2. The last sell signal to show on the chart is the lagging *death cross* as the 50-day moving average drops below the 200-day in Exhibit 9.3. By then, price is cascading down in a free fall. There are no supports on the way down for a sharp selloff like this except the bottom. Finally, there is exhaustion selling and the dead cat bounce up that sucks in the bargain hunting bulls for a bull trap from $62 to $133 before collapsing again to $52 in Exhibit 9.4. This chart is an unmitigated disaster that portfolio managers would love to avoid. Selling at the bottom kills their portfolio performance. Portfolio managers must catch the early sell signals before the fundamental defects become well known. For that they must learn to use technical analysis.

YOU MUST HAVE A SELL DISCIPLINE

In Exhibit 9.1, you see the extreme July move down in the stochastic and the MACD compared to all the previous weeks on the chart. The 20-day exponential moving average drops below the 50-day, and now both are in downtrends. Price has dropped over 20 percent from the high.

For the first time on this chart (Exhibit 9.1), you see the 50-day changing to a downtrend and the 20-day crossing below the 50-day. There is nothing but sell signals on this chart, and price is now at $232 and has broken three price support levels ($280, $255, and $240), which is very bearish. More easily seen is that price broke below the 20- and 50-day moving averages.

What is your sell discipline going to be? Will it be 10, 15, or 20 percent of the recent high? Will it be when the 20-day or the 50-day turns down? Or will you wait for the 200-day? Or will you sell when price hits what you

EXHIBIT 9.1 NFLX, August 10, 2011, Weekly
Source: StockCharts.com.

paid for it? It all depends on your risk aversion level, but pick one of these sell disciplines and don't hesitate to sell. "You can never go broke taking profits." If you are wrong, and you will be sometimes, just move on to the other 4,000 stocks out there and pick another outperformer. Pick stocks that have good fundamentals and good performance because that is the way to beat the index. Avoid the white swans that have excellent fundamentals and weak performance because that is a good way to underperform the index. Most portfolio managers will give up on a stock when the 200-day moving average is violated and price keeps going down. This signal is shown on the chart in Exhibit 9.2.

The dead cat bounce up in January 2012, which never even reached the 200-day moving average, was a gift to those who failed to act on the first sell signals. The proverbial dead cat bounce is a gift to procrastinators, allowing them to sell into strength as price bounced up to $133. At least they were out before hitting $63.

Netflix was a high flyer that came crashing to earth when they made some missteps in their goal of transitioning from the old, cheap, popular, and very profitable DVD by mail to the more expensive product of the future, direct streaming of the movies into the home. The exhibit shows what happened when Netflix switched its focus from DVD to direct streaming. It was a disaster for the stock.

Unlike the surprise announcement that took Green Mountain down without a warning, Netflix's announcement shocked, but the market was

EXHIBIT 9.2 NFLX, June 8, 2012, 5-Year
Source: Yahoo.com.

previously aware of the transition problems. It was not aware of how mismanaged it would become. What was needed was a slow, seamless transition but what was used turned out to be a quick "chop shop" transition that failed. Management quickly corrected their error, but it was too late for the stock price.

DEATH CROSS, DEAD CAT BOUNCE TO A BULL TRAP, DOUBLE BOTTOM

Exhibit 9.3 shows the lagging or final sell signals. Price breaks below the 200-day moving average at $203 in August 2011, recovers briefly, and gaps down with a sell signal falling below the 200-day with conviction. The CMF falls below the line; OBV is falling, confirming the money flow out of this

EXHIBIT 9.3 NFLX, June 11, 2012, Daily
Source: StockCharts.com.

stock; and the MFI is oversold, indicating that the sellers were active for some time. If you remained unconvinced that this is a sell, there was no doubt after the next enormous gap down from $210 to $170 in price. CMF craters in the red.

As you can see in Exhibit 9.3, the last of the sell signals, the lagging signal called the "death cross," appears as the 50-day crosses below the 200-day at $140 in September 2011. Now go back and see the drop in July for the MFI, as this overbought oscillator acts as a leading indicator to the death cross and a leading indicator to the drop in CMF in August, at $203. CMF and OBV fall out of bed in September, and price drops to $74 in October 2011. By December it hits bottom at $63. Those who sold short at $203, when the 200-day was violated in August made a $140 profit if they covered their short by buying at the bottom.

BUY SIGNALS TO DOUBLE YOUR MONEY ON THE DEAD CAT BOUNCE

This disaster was followed by the "dead cat bounce" up, with the top of the dead cat move coming at $133, more than a double from the bottom at $63. There is nothing but long-term sell signals in Exhibit 9.3, but hedge funds and traders are willing to play the dead cat bounce up and in this case it turns out to be very lucrative until the long-term sell signals smash it at $133 and take it to the bottom again. It was a bull trap at the middle peak of the classic "W" bottom. It happens every time you have a double-bottom formation.

The first signals in Exhibit 9.3 for the traders planning to play the bounce are a bottoming pattern in December 2011 and the price breakout above the 50-day on January 3–4, 2012, at $80 and reaching $100 in the next few days on a spike in volume. Sharp moves up in CMF and MFI show the very strong demand. This is a buy signal, and price peaks at $133 by early February, as shown on the chart.

For a micro view of what was happening during the dead cat bounce, here is an article of mine published by MarketWatch.com on Friday, January 27, 2012, titled "Trading Netflix's Big Surprise," the day after Netflix jumped 21 points from $95 to $116 on a big surprise:

> *Trading the market, when it is dead wrong on a stock, is always profitable. Netflix is a case in point, up 21 points on Thursday, catching most of the analysts by surprise. They were 29 to 6 negative, with a mean, 12 month target of 82 according to Yahoo. Now several have raised their targets to 130, after the positive surprise. The chart now*

shows a breakout above the long-term down trend in price and bouncing up from a bottom. What are traders looking for going forward? Profitable trades, of course, and here is how.

Surprises like this always result in an inefficient market price loved by traders. They know that eventually the market will settle down and hone in on an efficient price for NFLX. But the profitable trading takes place as the market digests all the new information on NFLX and heads for that price. Upgrades by analysts, caught short by the news, certainly play in this equation. Likewise, the 21 point pop in price on Thursday reflects, not only the analyst upgrades, but panic buying by those who were short the stock. They have to buy to cover. The nice part about all these cross currents is it provides a level playing field for the small trader and even the investor. The portfolio managers and analysts are playing catch up and, usually, they have an advantage and are well ahead of the market, the small trader or investor. It is nice to play the game when the professionals have temporarily lost the edge.

Technical analysis has many ways of describing what can happen to price after a big surprise gap-up in price, as we have with Netflix. Thus a technician and a trader might be looking for a 50% retracement of the gap up, which might target 105. The Point & Figure chart shows support at 104. Thus a trader would be looking for a profit-taking pullback to this price level. Price has already pulled back from the high 119 on Thursday to the 116 close. Thus traders who were looking to short the over-bought signals, started selling at 118–119. And the Point & Figure chart had already identified resistance at 120.

Thus the forces that will continue to drive price higher, or prevent it from dropping at current levels, are the shorts and the analysts. Approximately 18% of the float was short, which is high. The short ratio is 1.5 so it may take a couple of days for all the shorts to do their buying to cover. In addition, some hedge funds will not cover at these prices, but will wait or try to drive price down to cover. They will find traders who are waiting to sell this gap-up. These are the forces that cause the proverbial filling of the gap-up in technical analysis. Likewise, more analysts will continue to upgrade over the next few days prompting buying. Then there are the portfolio managers just waiting to sell into this kind of strength because they decided to do that some time ago and were just waiting for this opportunity to sell, in size, into strength.

All of these forces will play out in price movements and traders will be waiting to spot buyer's exhaustion and then join the selling in taking price down to test support. If the analysts had not reversed

themselves, raising the target to 130, more than likely the gap-up would have filled and price would return to 95 again. As it is, that is unlikely. More likely is a pullback to 104 where a target of 130 becomes attractive again. Then a run-up again to test resistance at 110, 115 or 120. The analyst upgrades to 12 month targets of only 130 has put a cap, of sorts, on up price movements until next quarter.

Longer term, there is what technical analysis describes as a "W" bottom. It is possible that this run-up is the middle peak of the "W" and that price will come back to retest the bottom again. Flat revenue growth next quarter or excessive expenses for growth would trigger a retest of the bottom if that bad news appeared in next quarter's earnings. That would be the proverbial negative surprise.

In conclusion, traders are waiting to short as soon as the buying ends. Investors are waiting to buy the pullback to support. A pullback to 100 and a move up to the 12 month target of 130 gives a nice 30%, if you can believe the analyst upgrades. Traders will also be ready to play the bounce up from support back to 115-120. The traders let the tape or the chart signals tell them when it is time to buy and sell. (Click here to see some of the signals traders will be using. Day traders use intraday charts.)

You can see the gap up in price in Exhibit 9.3. Not in my wildest dreams did I think it would go up to $133, exceeding the 12-month target of $130. The mean analyst target was still well below $130. Whatever was driving demand, it wasn't fundamentals, but perhaps the shorts were the culprits.

DEAD CAT BOUNCE UP FAILS

The gap up was not filled right away, but was eventually filled when price dropped to form the double bottom at $61 in June 2012. In my article I did mention the possibility of a double bottom on any bad news, and that is what happened to Netflix.

As you can see in Exhibit 9.3, in April 2012 at $110 all of the sell signals are in place for a move back down to $63. CMF is below the line and heading down, OBV is in a downtrend, and the 50-day trend has turned down. Price not only failed to break above the 200-day downtrend, but it also failed to even touch or test the 200-day. In addition, price failed to put a higher high in place. The first high of the dead cat bounce up on Exhibit 9.3 was in February 2012 at $133. The second high only reached

$123 in March, and that failure to make a higher high was a deadly signal of supply. If you can't see this in price, then the CMF and OBV gave you the same signal.

How do you know it is a dead cat bounce up that should be shorted? Let's go to the back to Exhibit 9.3. The money flow and OBV turned up. But the key to not falling for these short-term signals is in the 50- and 200-day moving averages. Notice the 200-day downtrend is still strongly in place, and nothing has pierced it to the upside. Neither price nor the 50-day has broken above the 200-day. Without those signals, it does not matter what the short-term signals are saying, unless you are day trading.

You can see another signal in Exhibit 9.4 that will prevent a portfolio manager from mistakenly buying the bounce up from the bottom and the one most important to portfolio managers. It is relative strength, price of Netflix versus the S&P 500 Index. Relative strength can be used with any index as a benchmark. Here, the chart setting is using the S&P 500 Index because it is the best-known benchmark for the market. As far as I am concerned, this is the ultimate, long-term signal in technical analysis for investors and portfolio managers. Finding leading indicators for this signal

EXHIBIT 9.4 NFLX, June 11, 2012, Weekly
Source: StockCharts.com.

is the quest for the holy-grail signal for portfolio managers. They need a reliable signal, a timely one, and a nonreversible signal that will tip them off to a trend change in relative strength. A rate of change of relative strength or some other derivative calculation may hold the key to a proprietary and very valuable signal in technical analysis.

The relative strength trend in Exhibit 9.4 is still negative, meaning that Netflix is still an underperformer versus the index. If you want to beat indexing, as most portfolio managers must do, your stocks have to be in an uptrend for this signal. Portfolio managers do not want to buy stocks that won't help them beat the index, unless they are bottom fishing or playing a special situation stock such as an undervalued takeover candidate. Small investors need to copy their example by staying in stocks with a strong long-term uptrend in performance relative strength that will continue into the future.

Why would investors still buy Netflix? Perhaps they want to bottom fish the double bottom in place. But Netflix has to prove it is finished bottoming, and that requires the technical signals to show a breakout of price and the movement of the 50-day above the 200-day for starters. To complete the signals, the relative strength trend at the bottom of the chart (NFLX: $SPX) must turn up, signaling that it is outperforming the index on a trend basis. That is the buy signal that will attract the interest of most money managers who refuse to bottom fish.

Picking bottoms is too risky for most small investors with little training in fundamental analysis. Copying portfolio managers who do this is also very risky because you have no way of identifying their winning picks and losing picks. The charts are no help until price breaks out to the upside with buy signals. You can put bottom-fishing candidates on a watch list and wait for the buy signals to appear. You could start that list with NFLX and FB.

One famous money manager, who made all of this money shorting Netflix on the way down, covered at the bottom to realize his great profits. Then he made the decision that Netflix was oversold and went long or bought the stock for his hedge fund because he expected price to go up. When you read this, you will know if he was right. Technicians will not own Netflix until they see some buy signals better than the ones you saw in the dead cat bounce up from the bottom. This turned out to be a bull trap for the long-term investor, but for the short-term trader it was a profitable double from $63 to $133, proving you can make a great deal of money on a dead cat bounce. Hedge funds love to do this. The buy-and-hold long-term investors made a round trip back to the bottom and failed to make anything. That is the problem with buy and hold and why hedge funds are popular. Hedge funds must use technical analysis to time a successful dead cat bounce trade such as Netflix, where they doubled their money from

November 2011 to February 2012. The small investor can do this much easier than the hedge fund that is buying and selling millions of dollars in a short period of time.

BROKEN "W" BOTTOM—NEGATIVE SURPRISE

The Point & Figure chart in Exhibit 9.5 shows the end of this disaster. When price is dropping, support levels are the previous resistance levels when price was on the way up. These resistance levels are clearly identified when the rising column of X's stops on the Point & Figure chart. On the way down, these very same points are now support levels. If these support levels don't hold as price drops, it is a bearish signal and a signal of increasing supply that will take price even lower. In addition to these former resistance levels that are now support levels as price drops, there are the other support levels at the bottom of each column of O's. This is where price stopped dropping and started a bounce up. These are important support levels from the past. Embedded in the columns of X's and O's are numbers that help you to identify the month of the year. A, B, and C are used to identify October, November, and December.

On Exhibit 9.5, the most recent data is found on the extreme right column. The recent columns on the right show that the "W" bottom at 63 failed, a major negative surprise, and went lower, looking for a new bottom. This bottom is yet to be established. This means supply is still in control taking price down. All sell signals are still in place; there is no confirmed bottom yet; there is no sign of a buy signal. It is still too early to buy, even for the bottom fishers.

In Exhibit 9.5 we have drawn the support levels in orange. Each time a support level is violated on the way down, it is a bearish signal of supply taking price down. Thus, on the left side of the chart, you can see the signals of supply that are going to take price down from $133 back to retest the bottom at $63. Each time price violates the support level, supply is in control and traders are playing the downside to the next support level. Some traders may play the bounce up, but the better strategy is just to play the downside all the way to the bottom. As Exhibit 9.6 shows, the trip down from $125 starts at the end of March and hits bottom at $61 in June—a steady decline that traders could play. On April 23, there is a big gap down from $102 to $86 and this one-day gap down is not apparent on the Point & Figure chart (Exhibit 9.6). It does show price dropping but not as a one-day gap down, which is an important sell signal. This is a weakness in using the Point & Figure chart. But the purpose of the Point & Figure chart is to identify support and resistance, and it does that very well.

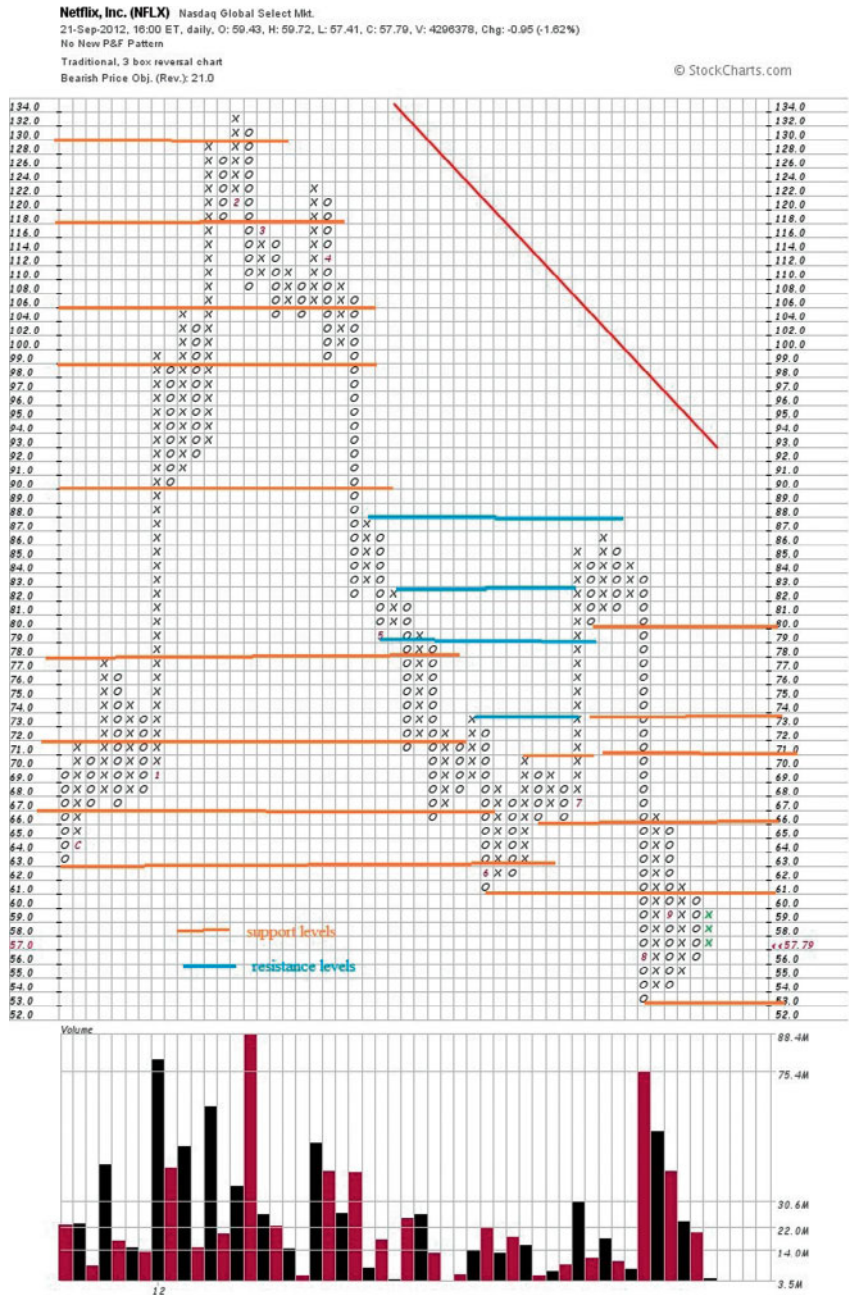

EXHIBIT 9.5 NFLX, September 21, 2012, Point & Figure
Source: StockCharts.com.

EXHIBIT 9.6 NFLX, September 21, 2012, Daily
Source: StockCharts.com.

SECOND DEAD CAT BOUNCE AND SECOND FAILURE

Price goes below $63 to $61 and then starts another dead cat bounce up to $87. Traders quickly recognize the demand coming in and play the bounce up. But, as Exhibit 9.6 shows, the move up happens very quickly in two trading days in the first week of July. Not many traders caught this one. Anyway, it turns out to be a bull trap.

Resistance levels are drawn in blue in Exhibit 9.5, and every time price moves above the resistance, it is a trader's buy signal. You can see the column of X's starting at $67 with the notation of 7 in the column of X's standing for July 2012 and moving straight up to $85, cutting through the blue lines of resistance, indicating very strong demand. Finally, the move is stopped at $86 resistance.

Price starts another move down, and once again the orange support levels are drawn. In one uninterrupted column of O's starting at $83 and ending at $53, price goes down, giving supply signals as it slices through every support level, including the very important bottom support at $61 to $63. In just one day, July 25 price drops from $80 to $60. There are no support levels on the way down when the market sells off sharply, and this can be clearly seen on Exhibit 9.5 as price drops from $83 to $53 in a single, uninterrupted column of O's.

The bottom fails to hold, and this is a very negative signal because now the process of putting a new bottom in place has to start all over again. Price is still in a downtrend, putting lower highs and now lower lows in place. Currently, the end of this process, finding the bottom, is unknown. The market hates unknowns.

Since the Point & Figure chart does not show price gaps or any of the other signals, let's look at Exhibit 9.6 to see the price action on the daily chart. This comparison will show you the value of looking at two charts instead of just one. You will see the gap down on April 23 and again on July 25. The CMF drops sharply just before the 20-point gap down on July 25, thus giving you an important heads-up warning of supply that will take price down.

Exhibit 9.6 also shows that the price break above the 50-day moving average in July 2012 does not hold. Price never reaches the 200-day, and that downtrend, an important sell signal, remains unthreatened and in place, warning the long-term investor to stay away. There is not even one buy signal on this chart at $53, but the double bottom has held so far at $53. Now the 50-day moving average has bearishly turned down instead of turning up to test the 200-day downtrend. Netflix does have enormous dead cat bounces, probably because of panic short covering called a *short squeeze*, and this could happen again at $53 if the shorts are greedy.

SUMMARY

This chapter showed what happens when a portfolio manager fails to recognize the sell signals warning him or her to sell as Netflix's price drops from $300 to $53. These sell signals are moving averages, especially the 200-day, violation of important Point & Figure support levels, CMF, and, most important, performance relative strength, OBV, MFI, accumulation/distribution, and MACD.

Traders and hedge funds need to recognize the buy signals on the dead cat bounce up that takes price from $63 to $133 for more than a double. These signals are the short-term double bottom, the breakout of price above the 50-day moving average at the beginning of 2012, confirmed by the PPO, OBV, MFI, CMF, and the break above resistance/support levels shown on the Point & Figure chart.

Successful Stock Signals for Traders and Portfolio Managers: Integrating Technical Analysis with Fundamentals to Improve Performance, Thomas K. Lloyd, Sr.

CHAPTER 10

Gaps, Divergences, Breakdowns and Breakouts, and Oscillators, with Research In Motion Exhibits

In this chapter, we compare a winner like Apple with losers like Research In Motion (RIMM) and Nokia (NOK). Hedge funds can make money on winners and sometimes even more money on losers. They can use a technique called *pairs hedging* to reduce their risk while they go long a winner and short a loser. Whether a stock is going up like Apple or going down like Research In Motion and Nokia, you will find technical signals like gaps and divergences to warn you of breakdowns and breakouts. You can use momentum signals and oscillators to catch the changes.

APPLE VERSUS RESEARCH IN MOTION, STOCK PAIRS HEDGING

For every winner there is a loser in the stock market. It is a zero-sum game. Because of Apple's tremendous success with the iPhone, competitors such as Nokia and Research In Motion become the losers. Hedge funds and individual investors with margin accounts can make money on both the winners and the losers. In this case, they can go long, buy stock in Apple, and short (i.e., sell borrowed stock), in Research In Motion or Nokia. When you do this, it is called pairs hedging because you are hedging your long

with a short that is usually related in some way such as being in the same industry or sector. Thus, if there is a market crash or major pullback, and all stocks go down, including Apple, then the short position in Research In Motion or Nokia will make you money and hedge, or cover, the losses you have in Apple. In an ideal world, the market is going up and Apple is going up, and the new Apple phone is crushing the competition, so Research In Motion and Nokia are going down. In this wonderful world, you are making money on both your long and short at the same time! And you are hedging your bets, thus reducing risk! You can see why stock pairs hedging is popular on Wall Street. In the real world, you will usually make significant money only on either the long or short in the pair, but probably not both. The purpose of stock pairs hedging is to hedge or reduce risk, not to have both a winning long and a winning short. If you are lucky, you will have two winners, but don't count on it.

Exhibit 10.1 shows the 5-year chart for Apple up around 400 percent and Nokia down about 50 percent. Let's presume you did not get the timing exactly right and only made 300 percent on Apple and 25 percent on Nokia. In addition, you had the free "insurance" the hedge provides when Apple has a pullback caused by the broader market. That is insurance without paying a premium! In fact, when you sell short, it puts cash into your account as your account receives funds for the stock you borrowed and sold short.

EXHIBIT 10.1 AAPL versus NOK, June 11, 2012, 5-Year
Source: Yahoo.com.

EXHIBIT 10.2 AAPL versus RIMM, June 11, 2012, 5-Year
Source: Yahoo.com.

Exhibit 10.2 shows the picture if you went long Apple and Short Research In Motion.

Notice that Nokia in Exhibit 10.1 starts its drop in performance earlier in 2008 than Research In Motion shown in Exhibit 10.2. The Research In Motion Blackberry phone was a stronger competitor, and the hit to Research In Motion was after Nokia started diving. Depending on your timing, let's presume you made only 200 percent on the Apple long and 25 percent on Research In Motion short.

In the remainder of this chapter, we will examine Research In Motion in more detail to find the technical signals that tipped you off when to go long and short. Our purpose in the case study of Research In Motion is to improve our use of technical signals already learned in previous chapters and to add a few more arrows to your technical analysis quiver. Gaps in price, breakdowns, and breakouts are easily recognized signals, while positive and negative divergences are tricky to learn.

THE FALL OF RESEARCH IN MOTION FROM $148 TO $35

The crash in Research In Motion coincided with the crash in the market as the Standard & Poors (S&P) 500 dropped from 1,300 in the second quarter of 2008 to 666 in the first quarter of 2009.

Portfolio managers had to act quickly in July, August, and September of 2008 to avoid the steep decline in Research In Motion from $148 to $35, shown in Exhibit 10.3. Just follow the lines marked "Jul" and "Oct" in 2008 on the chart, and you will see the drop in price and the sell signals that told portfolio managers to sell. However, Research In Motion actually sold off worse than the market, and that sell signal for the portfolio manager can be seen in the relative strength (RIMM: $SPX) at the bottom of Exhibit 10.3. The relative strength trend turns from up to down before October 2008; this identified the change in Research In Motion from outperformer to underperformer. Research In Motion was crashing worse than the market. It was not a stock portfolio managers wanted to hold during a bear market.

First. you look at volume and price changes on the price chart before you look at the technical signals. In 2007, there is a strong uptrend in the 40-week red line (200-day) moving average, and price drops down from $137 to test that uptrend at $80 in January 2008 on the chart in Exhibit 10.3. There is some abnormally high volume. Then price comes back up strongly and puts a new high in place but not on strong volume. Next, in July 2008, price drops from the new high at $148 breaks below the 200-day at $115 and goes almost down to $100. This is a bearish break below the 200-day. This sell signal puts you on notice of possible trouble ahead. Research In Motion is now on the portfolio manager's sell watch list.

NEGATIVE DIVERGENCE

Before continuing, let's go back to the April ("Apr") line in 2008 going up and down the chart to find some warning signals. The first important one is a negative divergence in CMF at the top of the chart. See how weak the money flow at the $148 high is compared to the very strong money flow at the previous high of $137. This lack of money flow at the new high, a negative divergence, confirms what you already noted in the lower volume signal. The selling volume was in big spikes, the buying volume was relatively low, and CMF looked anemic even though price put in a new high.

Those technicians only looking at price will miss the negative divergence. The CMF signal is adding value because it is very easy to see how weak looking the new high is. Using price alone would lead you to the wrong conclusion that this is a strong new high at $148 and there is no problem. The CMF and the dropping MFI line from overbought is warning the smart technicians that price is going down. MFI tells you that price is coming down from overbought in a selling cycle heading for oversold.

MFI also provides a negative divergence after the July 2008 violation of the 200-day moving average near $100. When price bounces up to just

EXHIBIT 10.3 RIMM, October 22, 2012, 5-Year, Weekly
Source: StockCharts.com.

above $130, MFI fails to move up and head for overbought. Instead, it just moves sideways. Both the MFI and CMF tell you that the bounce to $130, while looking strong on the price chart, is in fact a very weak move up and not sustainable. As a result, price comes down hard, breaking below the 200-day moving average for a sell signal.

After the July 2008 sell signal violation of the 200-day and the bounce up, which puts a lower high in place just above $130 and lower than $148, price drops dramatically on spikes in volume, crashing through the 200-day for the third and final time. By October price was down to $40.

Here are the iPhone release dates to compare with Exhibit 10.3:

- Original iPhone on 6/29/07
- 3G on 7/11/08
- 3GS on 6/19/09
- 4 on 6/24/10
- 4S on 10/14/11
- 5 on 9/21/12

Not only did the market crash take Research In Motion down, but the iPhone releases kept it down.

DOUBLE BOTTOM, DEAD CAT BOUNCE, DOUBLE TOP, CAPITULATION

In Exhibit 10.3 the other usual signals in technical analysis play out. MFI, OBV, and accumulation/distribution drop sharply. Relative strength (RIMM: $SPX) flashes a sell signal by turning down. A double bottom is put in place at $35 in March 2009, and the double bottom is underlined on the chart. The usual dead cat bounce up from deeply oversold occurs, and you see price bouncing up to $86 in June 2009, for more than a double in a few months if you bought at the bottom. Traders and hedge funds, as well as some value players, play these dead cat bounces. Doubling your money may be worth the risk of trying to pick the bottom.

In September 2009, a double top is put in place and you connect the two tops, $86 to $88 with a line on the chart in Exhibit 10.3. This double-top warning, that the dead cat bounce may be over, turns out to be true. Price breaks down into a lower-lows and lower-highs pattern, and you identify this bearish pattern with lines connecting the lower lows and lower highs. This bearish downtrend gives way to the final crash to a new and much lower bottom than the previous $35. At the end of the chart, on the right, price drops to $6.

The lesson for the portfolio manager and investor is to be found in the many sell signals issued before price hit $6, and these early signals would have saved a great deal of money for the investor. The lesson for the traders and hedge fund managers is: how many signals were issued so that one could trade in and out of Research In Motion on the way to the $6 bottom?

OVERSOLD/OVERBOUGHT OSCILLATOR

The MFI is an overbought/oversold oscillator, and you can see in Exhibit 10.3 the labels identifying the scale where this signal appears in the overbought and oversold territory at scale lines 80 and 20. In July 2007, it breaks above the scale line at 80, which is located on the right side of the chart. The peak is in green, indicating that price has moved up strongly to trigger the overbought signal caused by extreme buying. It is also a contrarian warning that price is very high and vulnerable to a pullback. The pullback does not happen right away. By January 2008 the MFI is moving down sharply and price hits the low of $80.20 before starting a bounce up. The MFI never breaks below the scale at 20, which marks the deeply oversold territory in red. The MFI moves back up to overbought again as price puts a new high in place at $148 in June 2008. Contrarian traders are selling short the overbought indicator at $148. However, stocks can remain overbought for some time, and you have to wait for the MFI signal to turn down and find confirmation using other signals.

As price hits $148, the MFI, acting as a leading indicator, has already started the journey down from the overbought signal. Any hedge fund that shorted this signal and stayed short until it turned back up at the end of the year would have made more than $100 on every share sold short. The failure of the MFI to turn up when price bounced back up to $130 was not only a negative divergence but a signal to short again when price hit $130. The shorts would have covered on the bounce up to $130 but would have gone short again as price dropped strongly from $130.

TRADING THE DEAD CAT BOUNCE

As you notice in Exhibit 10.3, trading the dead cat bounce in Research In Motion from $35 to $86 was very profitable for any hedge fund, trader, or even value player looking to double their money on the risky bounce up from the bottom. Let's look at the buy signals that would have given such a trader the courage to put money to work at the bottom of a bear market selloff.

Exhibit 10.4 shows the daily signals for the dead cat bounce starting in March 2009. Here, the buy signals are identified as price moves up. The first thing you will notice is that technical analysis will not have you buying at the $35 bottom. The only ones coming in at $35 are the fundamental value players who believe $35 is the valuation bottom and that the double bottom profile at $35 will hold. Technicians want to see the bottom hold, followed by some buy signals that will show a breakout off the bottom. Without the breakout buy signal, price could keep bottoming indefinitely, bouncing along the bottom in a trading range killing portfolio performance.

RESEARCH IN MOTION BREAKOUT BUY SIGNALS

At the end of March you will see the first buy signal identified by the blue arrow on the stochastic signal at the bottom of Exhibit 10.4. Demand is beginning to take price up, but will the demand be strong enough for the breakout buy signal? The answer is yes, and you see arrows identifying the increased volume and big price moves to the upside at the beginning of April.

The breakout buy signal comes as price reaches for $50 on a gap-up open in price and breaks above the important 50-day moving average red line on more than double normal volume. This is enormous demand for a stock that is coming up from a double-bottom profile at $35. Unfortunately, the trader has missed 15 points off the bottom, but as the chart shows, the ride up from just below $50 to $86 will provide a 72 percent return in three short months. Risk is now low because this is a strong breakout move up confirmed by a gap in price and a volume spike indicating very strong buying demand.

The trader had only two days to make a positive decision at just below 50 because this breakout buy signal is followed by an enormous 10-point gap-up from $50 to $60 on an even bigger volume spike. This enormous buy signal now makes Research In Motion a no-brainer for the rest of the trip up from $60 to the high at $86. Every technician is now into this stock with very low risk and, of course, lower returns.

Usually, after an enormous gap-up, there will be some give-back in price. Price would normally come back down and fill some of the gap-up. You could expect to see 50 percent of the gap-up filled, or in some cases 100 percent. But the demand is so great for Research In Motion stock that price fails in its attempt to go back down and fill some of the 10 point gap-up. This is another confirmation of the enormous demand that is going to take price higher short term probably fed by panic short covering or a "short squeeze."

EXHIBIT 10.4 RIMM, October 2, 2009, Daily
Source: StockCharts.com.

Day traders are buying every pullback during the day, and proprietary trading desks in the institutional brokerage firms are holding their positions open overnight looking for higher prices to come. With the enormous gap-up buy signal, nobody is selling this stock short until a top is put in place and there are definite sell signals showing on the chart to take it back down.

The other technical signals on the chart confirm what every trader knows from the price and volume action. At the top of the chart, the CMF breaks out above the line into the green at around $64 and stays in the green until $86. This lagging signal gives you a 34 percent gain in three months.

The next signal at the top of the chart, the MACD, had you in Research In Motion at $40 as the bars broke to the upside on this indicator and out at $78 when the bars failed miserably in attempt to go above the horizontal again. This 38-point gain using the MACD signal would give you a 95 percent gain. You would have bought early and sold early. The buy point was risky, and the higher return reflects the riskier strategy.

Notice that the blue arrow is pointing to the second consecutive move up in the MACD signal. The MACD bars had started to come down in a regular cycle weakness. All of a sudden, the cycle is reversed and instead of continuing down, it goes up for a back-to-back up cycle. This is usually very bullish for any stock. Whenever the MACD is extended into double or triple peaks, there is something important going on in demand if it is above the line or supply if it is below the line. In this case, you have a strong confirming signal of demand telling you that price will continue to move higher. This is also confirmation that price is not going back down in any attempt to fill the gap-up between $50 and $60.

Let's move to the price and candlestick part of Exhibit 10.4 to identify the purely price movement signals. The initial buy signals in price and volume in the very first days of April 2009 were discussed earlier. Now you want to look at the other blue arrows pointing to buy signals in price movements. There is a blue arrow at the gap-up in price between $50 and $60 identifying this gigantic buy signal. This signal triggers most of the technical buy signals below the chart, namely the stochastic, RSI, OBV, ADX plus D1 and minus D1 and RIMM: $SPX. We have blue arrows at each of these technical signals to show the big positive jumps caused by the 10-point gap-up in price with confirmed extraordinary volume.

There is a blue arrow that points to the crossover of the 20-day moving average above the 50-day. Then the lagging 50-day crosses above the 200-day for a "golden cross." Since this turns out to be only a dead cat bounce up from the bottom, the golden cross is not so golden. Usually, this crossover signals a continued long-term trend back to the old high, but not so here. Instead, as shown in Exhibit 10.3, price puts a double top in place

at $86 to $88 and starts a two-year downtrend in price that ends at a $6 bottom capitulation.

Research In Motion crashed and burned, and technical analysis provided signals for investors and traders all the way down. Trading in and out of Research In Motion on the way down was a much better strategy than buy and hold. Using a simple 10 percent sell discipline, where you sell when price has dropped 10 percent from the most recent high, would have saved small investors much grief because Research In Motion fell so quickly from a high of $148.

Whatever your sell discipline is, it must be an iron-clad discipline, and you must act on it without thinking. It has to be a metric trigger, and it must be on automatic pilot. It could be a violation of the 50-day moving average or the 100-day or the 150-day, or the one watched by most portfolio managers, the 200-day moving average. Whatever one you select as a sell discipline based on your risk sensitivity, pull the trigger and sell when the moving average is violated. In most cases, you will be able to wait for the bounce up to sell into strength.

In extreme cases, like the market and stock crash of Research In Motion, you must sell as soon as your sell discipline is set off by some price metric. There has to be a line drawn in the sand by you, and if price crosses that line, you sell. You determine the line based on your own personal risk parameters, but establish that line in the sand and use it without giving it any thought whatsoever. You must take a small loss to avoid crashes like Research In Motion. With brilliant short sellers out there, such as David Einhorn, you have to be ready to sell Green Mountain Coffee, Chipotle, Herbalife, or any other stock that could crash because it is greatly overvalued and some famous short seller makes an announcement about it.

As you know, the most important indicators in technical analysis are leading indicators. The following were the leading indicators to the move up from the bottom at $35 and were seen before the gigantic buy signal at $60.

- First and foremost is the gap-up in price to just below $50 on very strong volume in the second trading day in April 2009. This breakout move also broke above the 50-day moving average, thus a double buy signal confirmed by volume.
- The first early sign of demand is in the middle of March when price at $38.77 breaks above the 20-day moving average and stays above it. Price continues its march up to test the 50-day at $46, thus confirming that there is increasing demand. It turns the direction of the 20-day trend to up.
- The stochastic, MACD, RSI, and plus D1 and minus D1 all were in positive trends before the first reliable buy signals noted above. These

were reliable leading indicators of demand. But the actual buy signals come after these positive signals. Many times, these signals will reverse themselves, but in this case they did not, and turned out to be leading indicators to the eventual buy signals in each of these indicators.

- The break of the green 20-day moving average above the red 50-day leads the break of price above the 200-day.
- The break of the 50-day above the 200-day leads the price move higher, to $86.

RESEARCH IN MOTION'S DOUBLE-TOP DIVE FROM $88 TO $6

Exhibit 10.5 displays RIMM's final death spiral from the bearish double-top formation at $88 to $86 to the bottom at $6 from 2009 to 2012. It starts off with a gap-down sell signal from $88 to $71 on the extreme right of Exhibit 10.4, confirmed by an enormous red spike in volume shown on the chart. This important signal is buried in Exhibit 10.5 and is not seen as clearly, but we have connected the double top with a line in the Exhibit 10.5. Looking at both charts shows the importance of looking at the daily chart for clarity of signals and the monthly for long-term trend, which is most important to the portfolio manager. Traders and hedge funds want to act on the daily signals, but long-only portfolio managers using a buy-and-hold strategy are more interested in what the monthly chart is saying about long-term trend.

Don't forget that fundamentals determine what these portfolio managers buy and hold. I never met a portfolio manager who did not use fundamentals first and foremost. They will sell quickly if the fundamentals change. Technical sell signals and a technical sell discipline will force them to sell as soon as they see the fundamentals turn bad. Technical sell signals will alert the portfolio manager to focus more closely and question more strongly the underlying fundamental thesis for continuing to hold a stock that is underperforming. It will set off alarms about possible fraud, as in the case of Enron.

Portfolio managers want to avoid being blind-sided by any sell announcement by David Einhorn on any stock in their portfolio or an announcement of a fraud "cooking the books" and falsifying the fundamental metrics used by the portfolio manager. Portfolio managers who refuse to use technical analysis will fall into every value trap and fraud out there, and there are many. That is why it is tough for the purely fundamental portfolio manager to beat the index.

EXHIBIT 10.5 RIMM, October 25, 2012, 4-Year, Monthly
Source: StockCharts.com.

RESEARCH IN MOTION: ALL SIGNALS BEARISH FOR THREE YEARS

After the double top at $88 and the enormous gap-down sell signal in Exhibit 10.4, you can see that all the long-term signals on the monthly chart in Exhibit 10.5 turn bearish. The CMF drops from green, above the line,

into red below the line, and stays mostly below the line all the way to the bottom at $6. The CMF moves deeper and deeper in the red as the bottom at the end of the chart, on the right, is approached.

MACD stays mostly below the line, encouraging the portfolio manager to sell into strength on every bounce up in price. Both the CMF and MACD are in sync and confirming one another in being bearish on this stock long term. The message is clearly: "Don't be fooled by the dead cat bounce up to $88."

The price part of the chart clearly shows the bearish pattern of lower lows and lower highs, confirming the double-top sell signal, followed by a downtrend in price. Every time price bounces up and fails to turn all the other signals positive, you have confirmation that Research In Motion should be sold into the strength of every bounce up. Unfortunately, if the market is crashing, mutual fund portfolio managers have to sell into weakness in order to meet redemptions by small investors. Likewise, index funds are selling into weakness. This kind of panic selling causes the market to be very inefficient, taking excellent stocks down to bargain basement prices. Index funds are mindless robots, and they don't care about how good a stock is; they dump the good stocks with the bad. That is why stock picking is so easy after a market crash because there are bargains galore created by index selling, which is totally dumb or agnostic to good stocks.

The bounces up in price in Exhibit 10.5 fail to change the downtrend in OBV, accumulation/distribution, and relative strength. Of all of these signals, the most important long-term signal for the portfolio manager is at the bottom of the chart, RIMM: $SPX, or relative strength versus the S&P 500 Index. As you can see in Exhibit 10.5, this signal starts in a downtrend and never recovers. It means the stock is underperforming the index, killing the portfolio manager's performance and forcing him to sell it. Portfolio managers are fired if they keep these underperforming stocks in their portfolio for very long. No portfolio manager would ever be fired if they moved past their fundamental bias and ruthlessly cut the underperformers in their portfolios. Procrastination is built into the system because portfolio managers "love" certain stocks, they have been big winners in the past, and it takes a long time to research and find good stocks. The fundamentals of the outperforming stocks are not as comfortable as the fundamentals of the underperforming stocks. As a result, the portfolio managers have a tendency to stay with the fundamentally strong losers that are hurting portfolio performance. They can't bring themselves to pick outperformers with acceptable fundamentals over stocks with excellent fundamentals but poorer performance.

Most of the portfolio managers screening for stocks on their computers to find new buys for the portfolio have a fundamental bias instead of a performance bias. They need to change the way they screen stocks to

buy. They need to weight performance relative strength more heavily in their screening and relax the fundamental bias. They need to use technical analysis as the first step. Picking strong fundamental stocks feels safer than picking strong performing stocks. Technical analysis has a bias for performance, while the portfolio manager has a bias for value. Technical analysis has a bias for future performance, while fundamentals have a bias for past performance.

SUMMARY

In this chapter, the long-term monthly chart was used and compared with the daily and weekly charts to see the value added for the long-term oriented portfolio manager. Using Research In Motion as the case study, the short-term signals on the daily and weekly charts were shown for traders, proprietary trading desks, and hedge funds. The use of negative and positive divergences was illustrated. Technical analysis signals on the charts include CMF, MACD, OBV, accumulation/distribution, ADX plus D1 and minus D1, relative strength, RSI, and the use of trend lines on the price chart and signals. Stock pairs hedging was illustrated using Apple, Research In Motion, and Nokia.

Successful Stock Signals for Traders and Portfolio Managers: Integrating Technical Analysis with Fundamentals to Improve Performance, Thomas K. Lloyd, Sr.

CHAPTER 11

Relative Strength, Elliott Wave, and Fibonacci Levels, with Priceline Exhibits

GUIDELINES FOR SUCCESS

The most valuable tool for the investor and portfolio manager is relative strength, that is, the price of the stock you are looking at versus the price of the market index (or the price of another stock in the industry or the price of the industry index). Investors are always looking for the proverbial "best of breed," and relative strength identifies best of breed in technical analysis. Portfolio managers using a sector rotation style of money management need to use this tool. Yet another way to evaluate both the long-term and short-term cycles and price levels is to use Elliott wave and Fibonacci levels. You will use all of these tools as you analyze charts in this chapter.

There is no way to predict the future whether you use fundamental analysis, technical analysis, or both. No matter what you use, whether small investor or professional portfolio manager, you stay in a winning stock until things change. In the case of fundamental analysis, you stay with a stock until it becomes overvalued or the growth slows or, for some unforeseen reason, the stock just blows up.

In technical analysis, you stay with a stock as long as the signals are positive. In particular, the stock must be doing better than the index, shown by performance relative strength. It needs a positive, 200-day uptrend in price that is outperforming the trend in the market. High-dividend stocks do not have to be so robust technically because the high dividend, when

added to price appreciation, may give a total return that classifies them as outperformers. Based on price appreciation alone, these stocks may have slightly underperformed the index, but the high dividend and total return may "boot" them up to outperformers.

For growth stocks, buy a strong uptrend and for high-dividend stocks expect a flatter uptrend. For cyclicals, buy the bottom of the trading range and sell the top. Sell signals have a domino effect, for example, first the 20-day moving average turns down, then the 50-day, and finally the 200-day. You are looking at other confirming signals such as money flow, on-balance volume (OBV), moving average convergence/divergence (MACD), stochastic, accumulation/distribution, pivot points, and the Point & Figure chart to come to a decision.

There are the exogenous patterns like Elliott waves and Fibonacci levels. I dislike these because they are not driven by the price and volume of the individual stock but are generalizations about numbers theory and patterns that seem to work on a recurring basis. They are only useful to the extent that traders believe in them and use them to create supply and demand, buy and sell decisions. But the driving force of price is always supply and demand and any factor that creates supply and demand. Sometimes it is the technical analysis signal that creates supply and demand. The best signals tell you what supply and demand are doing, which determines where price is going for each individual stock.

PRICELINE FIVE-YEAR PERFORMANCE VERSUS APPLE

You are going to look at the chart of another winning stock, Priceline. First, let's compare Priceline to Apple, over five years, to see which did the best. As you can see in Exhibit 11.1, Priceline, the top line on the chart, outperformed Apple, the lower line on this performance chart.

Bouncing up from the 2008 market crash, Priceline bounces up faster than Apple and maintains that performance edge over time. By the end of five years Priceline has even improved its performance over Apple. Here again, you have another example of fundamentals versus performance**.** If the portfolio manager has a fundamental bias he will pick Apple over Priceline. If he is intent on beating the index, he will use technical analysis to overcome his fundamental bias and pick Priceline with good fundamentals and great performance over Apple with outstanding fundamentals but performing worse than Priceline.

We are just trying to illustrate the point of performance versus fundamentals. In reality, since Apple and Priceline are in different industries, the portfolio manager would probably own both of them. But the chart does illustrate the constant dilemma of picking stocks with performance

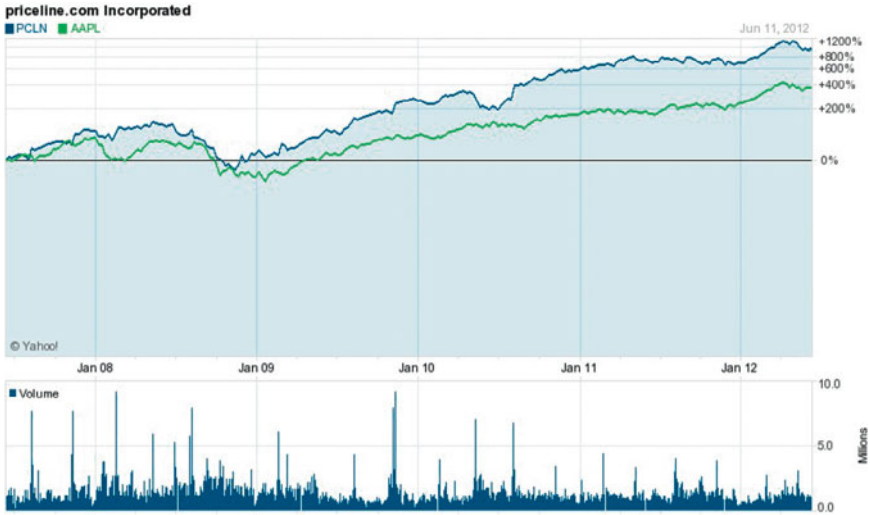

EXHIBIT 11.1 PCLN versus AAPL, June 11, 2012, 5-Year
Source: Yahoo.com.

and good fundamentals versus stocks with weaker performance but better fundamentals. The small investor faces this same challenge and can solve it with technical analysis to beat the index.

CASE STUDY CHALLENGE FOR PRICELINE

The purpose of the case study is to outline the planning premises before the earnings announcement on August 7, 2012. Coming up with the correct earnings for Priceline does not get you an "A" in the course. Highly paid fundamental analysts are not paid for guessing the next earnings correctly. Providing a good analysis of Priceline before earnings and having strategies to handle both the possibility of good earnings and poor earnings, will put you at the head of the class. It is difficult to predict earnings for a company even if you are an insider. (I know because I once was an insider preparing those earnings estimates.)

The Wall Street analysts are at a big disadvantage because they do not have inside information. Even if they did, it might not help. What the analysts are paid large sums of money for is their knowledge of the company. Using financial models helps them to ask intelligent questions about the company's operation and financial results. It does not give them the ability

to predict earnings for the company. Their earnings estimates are based on company guidance. Companies can be wrong on their guidance even with inside information! Analysts' price targets are educated guesses and their only value is to tell you what the analyst's opinion really is. The financial models do give the analysts the ability to see why the company beat estimates or why they missed their earnings forecast and where.

Our purpose is the same with the case study approach to earnings. The objective is to understand what the consensus, educated, earnings guesses were before the announcement and what the chart was telling you in terms of supply and demand. After earnings are announced you will know what to do. You will have formulated a strategy for good earnings and bad or earnings that were neither good nor bad.

FUNDAMENTAL MODELS

First, you can go to a resource such as Trefis.com to see what its fundamental models are saying and what its community of users is targeting with different reiterations of the same model, using different assumptions for revenues, margins, product mix, and so on. Pure technicians have no interest in doing any of this. Since I, at one time, designed and used such financial models, I like to play with them.

The article "Priceline Shares Slip Ahead of Q2 Earnings Amid Europe Weakness and Forex Pressure" by Brendan Gilmartin, Selerity Research on Priceline, was initially published on SeekingAlpha.com on August 6, 2012, and was widely available via Yahoo.com and MarketWatch.com news feeds. Using both fundamental and technical analysis, it provides a nice summary before earnings on August 7 with Priceline earnings due after the close. (To view the article, especially for those using the case study method, go to the book website using the password found at the end of the book. Or you can do a search for the author on SeekingAlpha.com.)

The planning premise here is that all of this information is already in price. Our thesis is always to use technical analysis as an overlay to this type of fundamental analysis, realizing that fundamental analysis is only one factor in determining price. Risk management may be a more important factor short term, as portfolio managers are forced to sell, not because of fundamentals, but because they have too much exposure. Likewise, mutual fund redemptions or index fund liquidations caused by a bear market move down, will also override fundamentals as a factor in pricing the stock. This article articulates very well what the fundamental factors are and what will create demand or supply after earnings come out.

After reading the Priceline article and looking at the charts, I posted the following to the author and other readers of the article on SeekingAlpha .com on August 7 at 10:16 A.M.:

> *Excellent preview. The big question is whether the test of the 200-day moving average is over or do earnings forecast take PCLN down to test 605? (negative surprise.) Before earnings it was showing slight demand and weak attempt to test 700 resistance. Will it make it back to 775 (positive surprise)? My guess is a repeat of last qtr.'s 5% selloff after earnings. PCLN is currently trading at $677. I liked the buy signal on July 27 enormous volume, gap and candlestick. This signal is not looking for a negative surprise.*

Thus, before earnings came out on Priceline on August 7, I had posted my opinion, "a guess." The purpose of this case study is not to guess earnings before hand, but to have strategies lined up proactively for action after earnings. After earnings, will you buy on weakness if it drops back to test the 200-day again? Will you sell out your position if you are a portfolio manager and it breaks the 200-day moving average? If the earnings forecast is good, do you chase price and buy in the hopes it is targeting $700 or $775 the old high? These are the questions for both investors and traders. These are the strategies and answers you need to formulate before looking at what happened to Priceline after the earnings came out on the close of trading August 7, 2012. Before you articulate your answers, you may want to look at the daily and weekly charts (Exhibits 11.2 and 11.3).

PRICELINE SHORT-TERM DAILY CHART SIGNALS

First, let's look at the daily chart on the day earnings will be announced for Priceline. In Exhibit 11.2, you will see that we have used the chart service tool that automatically puts in the Fibonacci retracement levels. These will be used to examine possible support and resistance levels. I will enhance the Fibonacci answer by looking at support and resistance levels established by price on the chart. Also I will use the 20-, 50-, and 200-day moving averages on the chart to look for support and resistance levels. When these three methods intersect, you have a powerful signal of support or resistance.

The "rule of thumb" 50 percent level (not a Fibonacci level) identifies resistance at $684, and price has recently been testing that level with no successful breakout. Price is currently at $681 and is moving up to test resistance again. Obviously, if earnings are good after the close, it will break out and the Fibonacci level, the 61.8 percent line, is at $700 resistance.

EXHIBIT 11.2 PCLN August 7, 2012, Daily, before Earnings
Source: StockCharts.com.

Now let's look at price movements on the chart to see where price has established support and resistance levels in the past. If you go back to April, you will see that $680 was a very important support level that launched a move up to the top near $775. That makes $680 a very important support/resistance level. In this case, it becomes a resistance level because price is below it and moving up. Since May 2012, price has tested $684 five times and failed to break above it significantly. This is strong resistance. It will come as no surprise to anyone that price is not going to break above this level unless Priceline meets earnings expectations.

Price movements on the chart do confirm the Fibonacci level resistance. However, the 20- and 50-day moving averages do not help. Price has broken above both of these indicators in a temporary bullish move up. A break above $684 resistance is needed to confirm the continued move up. We will see if the earnings report provides that kind of news. If it does, let's look at the resistance levels that Priceline will target on a breakout above $684. The Fibonacci level at $703 does not have the numerous price tests of $684, thus it is a weaker resistance area. If you go back to April, you can see a weak bounce up from this level when price was moving strongly to the downside. Also in April was a positive hammer reversal candlestick that was the first indication of the move that went to the top. A positive surprise in Priceline earnings would probably breeze past this weak resistance level and move to test the old high at $760 to $775.

Now using the daily chart (Exhibit 11.2), let's see where support is if the news from Priceline is bad. Here, you have price supports, Fibonacci supports, and moving average supports. If the earnings news is neutral, price will probably retest the 50-day moving average and price support at $640, which has been tested five times. If the news is really bad, price will go down to retest the recent bottom around $600. That is also where the 200-day moving average intersects with the price bottom support level making it a strong support level. That does not mean it would stop any dramatic move down, but it might stop it temporarily for a bounce up. Exhibit 11.2 is the daily chart at 12:37 P.M., before the earnings report as the Standard & Poors (S&P) 500 Index moves above 1,400, helping Priceline to move up on the day.

PRICELINE LONG-TERM WEEKLY CHART

On the weekly Exhibit 11.3, you see the long-term weekly view on the day before the earnings are to be announced. I placed a comment on the chart some weeks earlier to remind me of my early opinion of the chart, namely, "confirmed buy on weakness, retest 774."

EXHIBIT 11.3 PCLN, August 6, 2012, Weekly
Source: StockCharts.com.

But on the date of this chart (8/6/12), I heard Marc Chaikin on TV give a negative view of Priceline before earnings. At the very top of the Exhibit 11.3 is the Chaikin Money Flow (CMF), and you can see it has fallen sharply from the green into the red. Marc Chaikin uses both fundamentals and technicals for his opinion. He is a "quant" as well as a famous technician and uses computers to quantify all of the fundamental metrics to come to his decision, as well as using his technical signals such as CMF for his iPad service published at www.chaikinanalytics.com. This, of course, gives me some concern. I also use a quant system and will show you what it is saying, but first Exhibit 11.3.

The most important signal on the chart is relative strength (PCLN: $SPX) and it shows that Priceline has gone from an outperformer (trend line up) to market performer (trend line flat). To some extent, this supports Marc Chaikin. The signals below the chart are neutral to slightly positive.

Looking at the price movement on the chart, you will see an enormous move up from $450 to $774 and the indicators such as money flow index (MFI), CMF, MACD, and relative strength are completely overbought (overextended). There is no surprise when it begins to sell off, not so much for profit taking as for risk management.

How bad is this selloff? It is bad enough to break below the 10-week moving average (50-day) but it does not go down to test the 40-week (200-day long-term uptrend). That is a good sign. It is possible that bad news on earnings will continue this move down to test the 200-day and even violate it. That would be serious.

Since the 22 percent selloff from $774 to $603, price has moved up slowly and steadily to $665 over the past 13 weeks. Unfortunately, there are no big spikes in volume to support the slight demand shown by price movement. If the news is good, price will move up to test resistance at $700. Bad news will take price down to test the 200-day moving average at $611. It would take a major negative surprise to break below the current very strong uptrend in the 200-day moving average. Really good news will take price back up to the old high at 774.

Now let's look at the Point & Figure chart (Exhibit 11.4) for support and resistance levels. You are looking for confirmation of the support and resistance levels found by using price, moving averages, and Fibonacci levels. I prefer using the Point & Figure chart to plan support and resistance levels.

As you can see on the Point & Figure chart (Exhibit 11.4), resistance levels are clearly identified by the tops of the X columns and support levels by the bottoms of the O columns. Starting with the most recent columns on the right side of the chart, you can easily glance to the right for the price level.

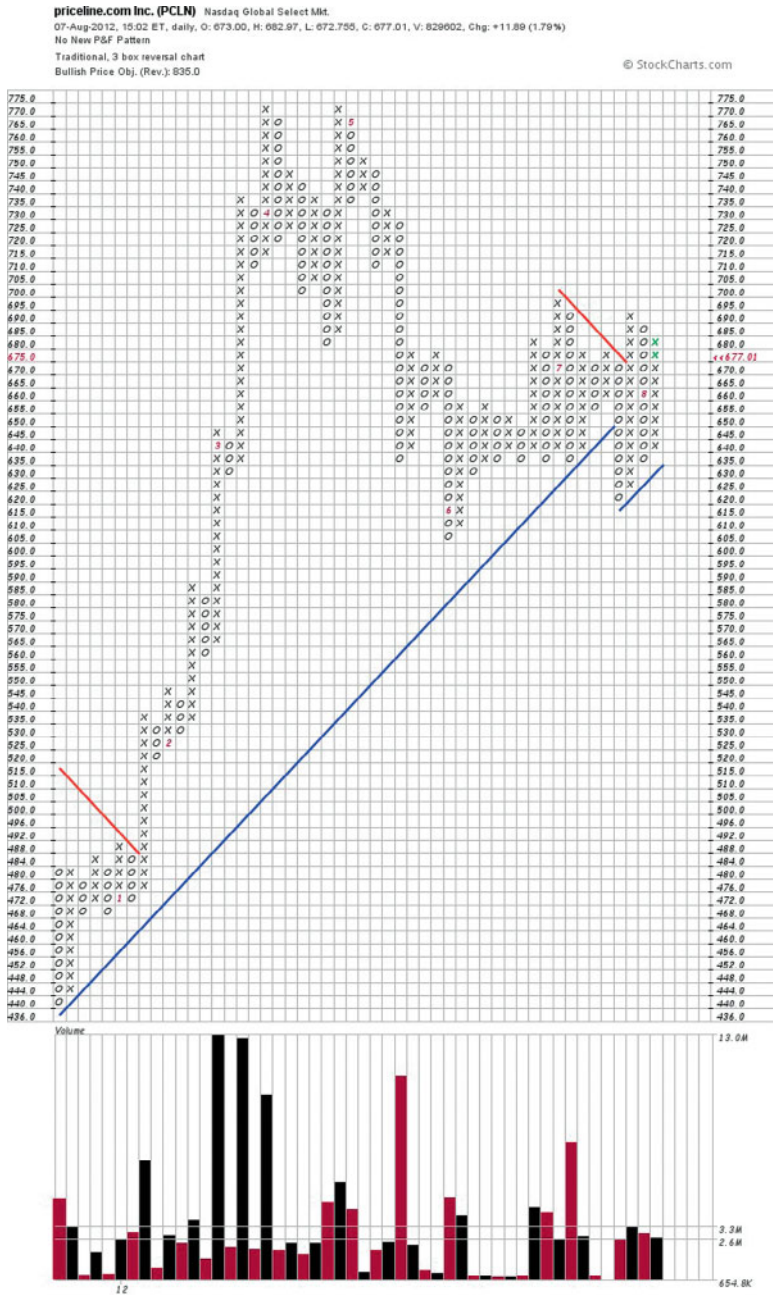

EXHIBIT 11.4 PCLN, August 7, 2012, Point & Figure
Source: StockCharts.com.

The latest column of X's on the right are identifying the move up in price just before earnings. The previous X column to the left topped out at $690 and that is the resistance level this current move up is targeting.

The column of O's just before the latest X column identifies the last test of support. You can see it ended at $635. The number "8" in the column identifies the month of August 2012.

If you want some other resistance levels, you can look at the higher columns of X's and where they topped out on the chart. You can pick off $735 as a resistance level. You can also look for resistance at previous support levels by looking at the bottom of O columns that ended above where price is now. Thus, you can look for resistance at $700, $710, $720, and $735. If the earnings news is neutral, these levels of resistance will slow any move up. If the news is good, price could breeze right through these levels.

Likewise, if you want to look for additional support levels, in case the news is bad, you can pick off some numbers from the bottom of the O columns: $635 is a strong one, tested by several columns of O's. Also, $620 and $605 are at the bottom of recent O columns. The top of X columns that were formerly resistance and are now support levels if price goes down are at $655, $645, and $585. Only an extremely negative surprise would take it down to $585.

ANSWER TO THE PRICELINE CASE STUDY

Priceline came out with a negative surprise in its earnings forecast after the close on August 7, and price dropped 100 points in the after-hours market to $585. Before the open of trading the next day, analysts were busy downgrading the stock:

5:48 A.M.	Priceline target dropped to $675 from $811 at Piper Jaffray.
6:11 A.M.	Citigroup lowers target to $740 from $850.
6:22 A.M.	Benchmark drops target to $725 from $840.
7:10 A.M.	Credit Suisse reduces target to $727 from $820.
7:15 A.M.	Stifel Nicolaus downgrades from Buy to Hold.
7:35 A.M.	RBC Capital goes from $780 to $720.
8:36 A.M.	Monness Crespi downgrades from Buy to Neutral.
8:37 A.M.	Preopen quote at $576.
9:11 A.M.	Pacific Crest lowers target to $687 from $885.
9:30 A.M.	Trading opens at $575.
9:57 A.M.	BofA/Merrill downgrades from Buy to Neutral.
10:00 A.M.	How low can Priceline go? My article published on MarketWatch.com.

MY POSTMORTEM ARTICLE ON MARKETWATCH.COM

I did not expect such a large negative surprise for Priceline earnings, but at least I had a strategy for it based on the case study analysis approach. I knew where the worst-case scenario would take price. I also knew what my strategy would be. I quickly wrote an article after the close on August 7 titled "How Low Can Priceline Go?" and submitted it to MarketWatch.com at midnight. It was published the next morning after the open of trading, at 10:00 A.M. Here was my analysis and I did not have the benefit of knowing all of the downgrades noted above. My article was written well before the analyst downgrades were published. Here it is:

Priceline issued a poor forecast, and the negative surprise took the price down 101 points to $579 after hours, breaking below the 200-day uptrend at $604. Is Priceline a broken arrow, or can it be fixed? That is what every portfolio manager holding PCLN is asking himself this morning. How low is low? That is the question on every trader's mind. Let's take a look at the charts and analysts after this sell signal.

Any bad news would have taken price down to test the 200-day moving average, because the last selloff made that attempt, but did not quite reach that low. The break below the 200-day shows how bad this news is and confirms we have a major sell signal to deal with. There will be an attempt to bounce up and test the 200-day moving average, but that will probably not happen today. It will happen when all the sellers are out of the way. Thus, where will the bounce start?

The point-and-figure chart spells out some clear potential support levels for the bounce up. Unfortunately, when stocks sell off like this, you can't count on any support level to hold until a bottom is put in place. This chart shows support at $585 and $560. The open of trading today will decide which support level is being targeted: $560, $585 or $605.

Some portfolio managers will have their sell orders ready to go on the open and the Wall Street institutional trading desks will welcome them with open arms at a price so low that they know they can make money trading the position higher. Other portfolio managers will wait for the eventual bounce up and sell into strength. That bounce will take them up to $605 if they are lucky, short-term. The next support level is at $535–$545.

Just looking at the weekly price chart and price levels, there is strong support at $550. It is not likely that will buckle near term,

but if it does, the next support level based on the weekly price chart is $450.

The analysts will be busy downgrading earnings for 2012 and issuing lower targets. If the analysts come up with $30 in earnings for the next 12 months and apply a reduced PE of 20, we have an implied target of $600. Discount that target back to today, and you have an implied price of $480 shooting for a $600 target in 12 months.

That $480 is close to our $450 worst-case scenario based on price support showing on the chart. But let's be optimistic and shoot for the $550 support level. The current frothy market will support a higher price. The lower analyst targets this year on Finviz.com are near $680–$690. Give them a 10% haircut and you are close to $600 I used.

The analysts won't be quick to downgrade while their institutional trading desks are awash with PCLN stock to sell to some bargain hunters. The only time a small trader has a level playing field is when a negative surprise like this catches the professionals flat-footed. Now the small trader has to decide if he wants to play the game of the institutional trading desks, buying low and selling higher. To do that, he has to wait for the sellers to be done and that may take more than one day.

According to Nasdaq.com, 14 out of 16 analysts had buys. Considering the 5% selloff after last quarter's earnings, that is surprising. We have to give credit to at least five analysts who downgraded earnings estimates since last quarter's earnings report. One analyst was even below $29 for 2012 vs. the mean analyst number of $29.81.

It pays to watch the analyst's downgrades of earnings instead of their recommendations and targets. My use of $30 to calculate a $600 target is obviously too high, but then my PE of 20 may be too low or it may not be low enough. StockpickerUSA.com's analyst revisions model warned us on June 29 and again on July 13 by going to a 7th decile rating where 10 is the worst. Obviously, it was picking up the analyst downgrades in 2012 earnings.

My conclusion? This earnings report confirms the selloff after the last earnings report. The portfolio managers that didn't sell then will probably sell now. If PCLN stays below the 200-day, it is a broken arrow. Short-term, it will be very difficult to get back above the 200-day and stay there. PCLN is probably dead money for the rest of the year, except for a dead-cat bounce up from the bottom. We don't have that bottom yet, but it could be $550 (or $450 worst case).

PROACTIVE BEFORE EARNINGS

As a result of the case study of Priceline before earnings, you were proactive waiting for the earnings announcement. You may not be able to predict such a negative surprise, but you can certainly be ready for the worst-case scenario, with a strategy mapped out from the chart as to where price will finally end up. You also will be ready for the dead cat bounce up from the bottom that will be targeting the resistance levels you have identified beforehand.

Being proactive before the earnings announcements, having strategies mapped out with specific support and resistance levels, enables you to act decisively once the earnings are announced. If you are a portfolio manager or an investor, and your sell discipline is to be out once price breaks below the 200-day and does not recover, then your sell discipline is now in motion. Your sell discipline needs to be on automatic pilot to remove all emotion from triggering a sell in your portfolio. The 200-day moving average is a simple and effective sell discipline. A change in relative strength from outperformer to underperformer is another. Both of these signals are clearly shown in Exhibit 11.5 for Priceline following the price and volume sell signal.

Exhibit 11.5 shows the three most important sell signals for any investor or portfolio manager:

1. This is the second and confirming sell signal in terms of both volume and price. The first was in May 2012, and you can see the spike in volume. Enormous supply is taking price down as indicated by price and volume.
2. Violation of the 200-day uptrend signal, confirmed by volume and price signals. Wait for and sell into the strength of the bounce back up to test the 200-day.
3. The violation of the relative strength uptrend and the transition from market performer to underperformer shown at the bottom of the chart. Ruthlessly weed out underperformers in your portfolio. Don't allow any of the lagging indicators in the fundamentals fool you into procrastinating on a stock with major sell signals.

Buying is the easy part of an investor or portfolio manager's life. Selling is the most difficult part. Emotions and procrastination are at work. That is why it is so important to use a quantitative, emotionless, sell discipline using the preceding sell signals. A sell discipline on automatic pilot is the key to beating the index. It is always possible that Priceline will be a buy next year, and if it is, you will buy it back at a cheaper price.

EXHIBIT 11.5 PCLN, August 8, 2012, Weekly
Source: StockCharts.com.

ELLIOTT WAVE TARGETS A $440 DOWNSIDE TEST

In Exhibit 11.6, you see the five Elliott waves that took Priceline to the top at $774. Under this wave theory, now that Priceline has completed the five waves up, it has entered a corrective phase of three legs down, identified as A, B, and C. The C leg is not completed yet. According to the Elliott wave theory, it could go down to test the bottom of the previous fourth leg up, which is $440. We will wait to see how that plays out in theory.

As indicated earlier, I like to pick out support and resistance targets from the Point & Figure chart. I am in agreement with the Elliott wave target, but I don't have a theory to get me there. I believe we get a bounce at $550 to $560 in at least one attempt to go back above the 200-day moving average. If support at $550 breaks, then it is on to $440 and Elliott may be right.

On August 9, 2012, I posted the following on Stocktwits.com using my name, StockpickerUSA. I was looking for a short-term bounce up from $560 where Priceline was then trading. But longer term I was pointing out the Elliott wave theory target of $440. Here is the way I posted it on

EXHIBIT 11.6 PCLN, August 8, 2012, Weekly
Source: StockCharts.com.

Stocktwits.com, which is linked and republished on my Twitter account @tomlloyd12:

> *stockpickerusa*
>
> *$PCLN 560 short-term bounce here but long-term Elliott wave shows final 5th wave end 775. Now a,b,c, downlegs long-term tgt 440 of 4th leg up.*

The only reason I posted the Elliott target of $440 was that I could see that on the chart. But I could not see the break below $550 that would take it to $440. In that respect, the Elliott wave theory may provide added value to the technician, if it is right.

SUMMARY

In this chapter, we have introduced and used the Elliott wave theory and the Fibonacci price levels to see if there is any added value in using these tools. In addition, we have shown once again, in our case study of Priceline, the other technical signals we are discussing and using in this text: Point & Figure, MFI, RSI, OBV, MACD, CMF, relative strength, and the 200-day moving average.

Key to this chapter is the explanation of sell signals and the importance of having a technical sell discipline that removes all emotion from the tough decision to sell a stock into the strength of the *dead cat bounce* back up to test the 200-day moving average it violated. A good sell discipline

must overcome the fundamental affection one has for a stock because it has been such a good performer in the past, maybe the darling of your portfolio.

A good sell discipline is automatic, emotionless and ruthless. Technical analysis provides such a sell discipline. Underperforming stocks are kicked out of your portfolio in order to beat the index. There are plenty of outperforming stocks with great fundamentals that you can switch to and selling PCLN forces you to look for them.

Successful Stock Signals for Traders and Portfolio Managers: Integrating Technical Analysis with Fundamentals to Improve Performance, Thomas K. Lloyd, Sr.

CHAPTER 12

Evolution of Technical Signals from A to Z, with LinkedIn Exhibits

Studying an IPO like LinkedIn shows the evolution of technical signals over time. For example, the 200-day moving average needs 200 days of data before it will ever show up as a signal on a daily chart. An IPO shows the evolution over time of the signals that become available as data becomes available. Unlike Facebook, a recent IPO with only a few months of trading, LinkedIn is an IPO with more than one year of data on price and volume. In this chapter, we will go from A to Z in the technical signals as they come online over time. The signals that are immediately available on the daily chart are the candlestick signals and relative strength versus the Standard & Poors (S&P) 500 Index and the Point & Figure chart. Also, on-balance volume (OBV) and accumulation/distribution are quickly available.

In 14 days, the money flow index (MFI) kicks in, along with the relative strength index (RSI). Rate of change is available in 12 days, but you can set it at 5 days for an earlier reading. Bollinger bands would usually come on the chart in 20 days. You can see the fast stochastic in 5 days. For day traders all of these signals are available during the first day, because instead of 1-day intervals, they are using 1-minute intervals. The 200-day becomes the 200-minute line. Likewise for the 10-, 20-, 50-minute trend lines.

LINKEDIN IPO SUCCESSFUL

The IPO price was $45. On May 19, 2011, public trading in the shares opened at $83 and went as high as $123 during the first day of trading. It closed at $94 and more than doubled for those who were allocated shares at the IPO price of $45. Now let's look at the technical signals you have after the first day of trading.

Unlike Facebook, LinkedIn was considered a successful IPO because those investors who received allocations of the IPO, before the open of trading, more than doubled their money in the first day. Exhibit 12.1 is the weekly chart showing this. You can see how long it takes for the Chaikin Money Flow (CMF), the MFI, and the moving average convergence/divergence (MACD) to start on the weekly chart.

Exhibit 12.1 shows that the signals that are immediately available after the IPO. As you can see, the MFI does not appear until the middle of August. It becomes extremely overbought in April and May 2012, and price eventually falls from that high perch. Here, you can see that a stock can stay overbought for a long period of time. Therefore, you have to wait for the signal to turn down before selling it short or buying put options. Portfolio managers use the lengthy overbought period to sell into strength, thus reducing their holdings to predetermined risk levels they have established for this stock.

LINKEDIN SELLOFF AFTER DOUBLING THE FIRST DAY

Notice the prices in the left part of Exhibit 12.1, traders were able to make a quick profit with the price doubling on the day of the IPO. In the three weeks that followed, you can see the three red candlesticks taking price down dramatically as sellers rushed in to take more profits. The first candlestick to the left on this weekly chart is a shooting star and is a negative reversal signal that warns of the red candles down that followed the shooting star signal.

The shooting star candlestick looks like a shooting star. There is a small body, meaning that the opening and closing prices were close together. There is a long wick or shadow line going up from the small body. This shows the high of the day, and you can see price went much higher than the close. At that lofty high, sellers came in and took price right back down to close almost where it opened. This shows great strength by the sellers and therefore is a bearish signal usually marking the end of the short-term move up. On a weekly chart such as Exhibit 12.1, this is an important longer-term signal because the weekly chart is for the longer term, whereas the

EXHIBIT 12.1 LNKD June 12, 2012, Weekly
Source: StockCharts.com.

daily chart is for the shorter-term decision making. This shooting star is followed by three weeks of profit taking.

After all the profit taking, price bounces up over the next four weeks from $60 to $110 in July 2011, almost another double if you bought at the bottom. The daily charts will examine this more closely and compare it to the Facebook IPO.

PRACTICE WITH THE LINKEDIN SIGNALS

The weekly Exhibit 12.1 is more important for the current signals that are showing. It gives you a chance to practice what you have learned about technical signals. You must come up with the answer as to what this chart is saying. Then, we will give you the chart as it actually played out to see if the signals on this chart were right. What are the signals in Exhibit 12.1 telling you on June 12, 2012?

The CMF at the top of the chart is in the green positive, but it has dropped from its peak over the past five weeks, marked by the four red candles showing that the close for each week was lower than the open during May 2012.

Just below the money flow is the MACD. The histogram bars drop below the horizontal line. Both dropping money flow and dropping MACD identify the shift from a buying cycle to a selling cycle in price. Since the MACD is showing no sign of turning up yet, you expect to see continued downside testing of the support at the 200-day moving average, currently around $88 on the chart. So far, so good. No real trouble yet.

Notice the start of the dominos falling on the moving averages. First, the 20-day turns down and then breaks below the 50-day moving average. Then, the 50-day moving average turns down, all confirming that you have a serious sell cycle that is testing the 200-day. But will the 50-day break below the 200-day, the proverbial "death cross" sell signal? That is the question traders, investors, and portfolio managers are wondering about as they look at this chart. That is the case study question for this chart for you to answer.

DO YOU BUY LINKEDIN ON WEAKNESS?

Before you answer the question "Is this a buy on weakness opportunity?" we have two more charts to show you.

In Exhibit 12.2, the percentage price oscillator (PPO) is showing that the selling (supply) is leveling off in June 2012 and may start improving.

EXHIBIT 12.2 LNKD, Weekly, PPO, Relative Strength Performance
Source: StockCharts.com.

The 200-day moving average has not been violated but is being tested at $88. You can see the 200-day first appears on the chart in February 2012. Last and most important to the portfolio manager is the comparison of this stock to the S&P 500 Index at the bottom of the chart (LNKD: $SPX). It shows that the uptrend has not been violated. But it does show the line dropping to test the 20-week exponential moving average (EMA). It is still in an uptrend and therefore outperforming the market on a trend basis. The line dropping down to test the uptrend indicates the LinkedIn is underperforming the market for the last several weeks and this is a sign of the supply that took price down.

Even though the stock was underperforming the market in the last few weeks as indicated by the relative strength line dropping down to test the uptrend, the uptrend still classifies this as an outperformer. A violation of this trend and a violation of the 200-day moving average by price would put this on the portfolio manager's sell-watch list. If these signals are not positive and corrected at the top of the next buy cycle, when the MACD histogram peaks above the line, the portfolio manager will use the price strength to sell into strength. So will the trader and the savvy small investor. They will use this to "front-run" price changes that are coming to the downside.

Exhibit 12.3 is the Point & Figure chart; it shows a bearish head-and-shoulders profile. Price is making lower highs and lower lows, another

bearish signal. It is a sell signal when the O's broke the right shoulder going down to $93 and again to $88 confirming the sell signal. Sell signals don't mean sell right now. Sell signals mean wait for the next buying cycle so you can sell into strength. If the sell signals are corrected by the next buy cycle, then, of course, you don't sell—you hold. You want to see confirmation of sell signals. Confirmation of sell signals occurs when they stay in place despite the next buying cycle indicated by the PPO and the overbought oscillator MFI.

The question is: would you buy this stock on weakness on June 12, 2012? See the case study below for how it turned out after the August 2

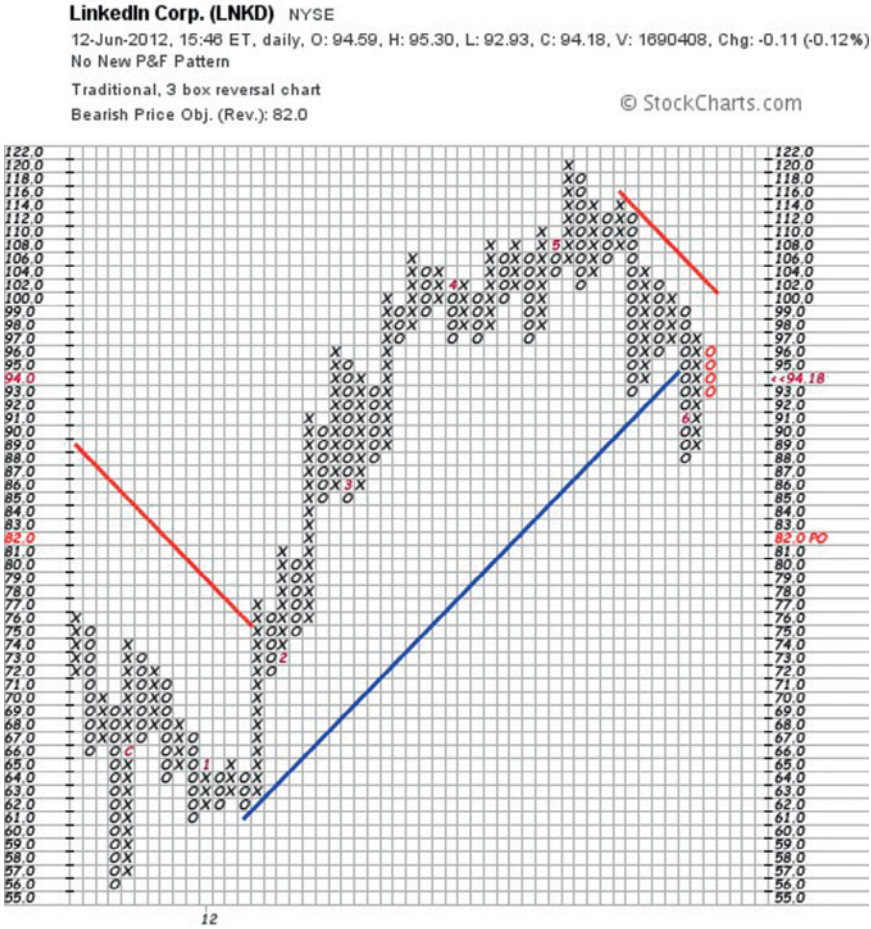

EXHIBIT 12.3 LNKD, June 12, 2012
Source: StockCharts.com.

earnings report. The August 2 charts (Exhibits 12.4 and 12.5) show that if you bought on the June 12 weakness, a short-term trade would have made money because it bounced up to $108. But then it pulled back again to $92 just before earnings on August 2.

What do all the signals on this chart mean? Let's look at a detailed explanation of each signal and how to use them properly in evaluating when it is time to sell LinkedIn. Overvalued stocks usually sell off, and LinkedIn is extremely overvalued and vulnerable to a selloff on the slightest bad news. Shorts are looking for overvalued stocks like this, but they will not short it just because it is overvalued. They will sell LinkedIn short when they expect a negative surprise in the future, such as a slowdown in growth and revenues or an increase in expenses that leads to a negative surprise in earnings. If competition increased or new entrants into the field appeared such as happened to Facebook, it might trigger a selloff in LinkedIn. For the time being, LinkedIn is delivering growth and profits and the short sellers have not been able to take it down.

LINKEDIN CASE STUDY CHALLENGE

It is August 2, 2012, and the case study challenge is to come to some conclusions before earnings are announced after the close in the market today. Later, you will find fundamental and technical information available to everyone before the earnings announcement. You will have to evaluate what the quantitative models are saying, what the Wall Street analysts are saying, and what the charts are saying before the earnings announcement.

The purpose of the exercise is not to guess what the earnings announcement will do to price, but rather what your investment strategy will be if the earnings are good or if they are bad. The quantitative models will show you how overvalued LinkedIn is. The 12-month price targets from Wall Street analysts will show you that there is a disconnect between the quantitative valuation and the estimates by buy-side fundamental analysts who are valuing LinkedIn higher than the metrics would justify. Finally, you will see in the charts that LinkedIn price is dropping before earnings reflecting the concern about what earnings news will bring in view of the extreme overvaluation in price.

Also contributing to the concern about LinkedIn on this date is the continued drop in Facebook. The Facebook earnings report was not good and price was still dropping from $28 before earnings to $20. Facebook started trading at $42 when it first came to market at a price of $38, an overvalued stock that was cut in half. LinkedIn does not have the supply problem created by Facebook because Facebook flooded the market with

too much stock. Unlike Facebook, LinkedIn doubled in price on its first day of trading because there was little supply of the stock and tremendous demand to own the stock. The extreme overvaluation of LinkedIn, the fundamentals, were not the driving force for pricing. Any bad news from LinkedIn will create supply and obviously take price down sharply because it is so overvalued. Good news will create more demand and take price up or stop the price from dropping further for the time being.

WALL STREET PRICE TARGETS FOR LINKEDIN

While waiting for LinkedIn earnings to come out, you can take a look at what the sell-side (broker's) fundamental analysts on Wall Street are saying. By going to Nasdaq .com, Finviz.com or Yahoo.com, you could have seen the following:

- The Wall Street analysts had it as a weak buy.
- There were more analysts negative (11) than positive (9).
- Their 12-month targets ranged from $92 to $150, with the consensus $135. Price was at $95. If you are looking for 60 percent growth and the 12-month target is $135, then the price should be around $84 if you expect it to grow 60 percent in one year to the target $135.
- Analysts were downgrading their earnings slightly over the past 90 days.
- Some downgrades were below the mean estimate of 16 cents for the quarter.
- The price-earnings ratio (PE) was 76 versus 45 for the industry, based on 2013 earnings forecast, thus overvalued and looking out to next year's earnings to justify price.
- Analysts were looking for 16 cents in earnings and $216 million in revenues to be reported after the close. The company forecast, which was about to be announced, was more important because the stock price looks ahead.
- Analysts were looking for 69 cents and $908 million for 2012 and $1.24 and $1.4 billion for 2013, thus revenue growth of only 37 percent. However, earnings were forecasted to grow by 80 percent versus a 2013 forecasted PE of 76.
- The estimated 5-year growth rate by the analysts is 66 percent implying a PE of 66 for a price-earnings to growth ratio (PEG) = 1.

There is absolutely no room for even the slightest disappointment in the pending earnings announcement.

WHAT THE QUANTS ARE SAYING

If you go to Trefis.com, you can use financial models to calculate the value of LinkedIn. You can do this by product line. Their quantitative models come up with a value of $44 for LinkedIn. People posting on the website, using their version of the quantitative models, come up with a $66 value. Here is some color that the Trefis team at Trefis.com added to the LinkedIn story:

VALUATION HIGHLIGHTS

Recruitment Services & Job Postings constitute 45% of the Trefis price estimate for LinkedIn's stock.

LinkedIn Ads & Marketing constitutes 29% of the Trefis price estimate for LinkedIn's stock.

Premium Account Subscriptions constitute 14% of the Trefis price estimate for LinkedIn's stock.

Share Count Calculation & Option Dilution

We have estimated the diluted share count to be around 116 million. This includes 102 million shares of Class A and Class B common stock outstanding after the IPO and the secondary offering, and roughly 13.4 million shares to account for option dilution. The company has about 14.8 million options at a weighted-average exercise price of $9.35 per share, and roughly 1.1 million restricted stock units. This data is available in the company's latest 10-K filing with the SEC. Without including the option dilution, the Trefis price estimate for LinkedIn stock would be around 13% higher than the present price estimate.

POTENTIAL UPSIDE & DOWNSIDE TO TREFIS PRICE

Below we highlight key drivers of LinkedIn's value that present opportunities for upside or downside to the current Trefis price estimate for LinkedIn.

Recruitment Services and Job Listings

Average Revenue per Corporate & Business Customer: LinkedIn charges companies for buying advanced solutions from LinkedIn, such as LinkedIn recruiter, Talent Direct, Custom Company Profiles and Jobs Network. We expect the average revenue per client company for LinkedIn to decline in the short-term and increase slightly in the long-term from around $24,250 in 2011 to around $27,000 by the end of Trefis forecast period. We believe that many of the incremental corporate customers for LinkedIn are likely to be small customers as

many of the large companies already use LinkedIn. These customers are then likely to spend less, which means the average fee could come down instead of going up. However, as the number of registered members on LinkedIn increases, it will benefit corporates by allowing them capture large talent pool for job offerings. This means that the average fee could actually go up in the short-term instead of going down. In the scenario where the average fees increases to $36,000 by the end of Trefis forecast period, there could be an upside of around 10% to Trefis price estimate for LinkedIn's stock.

Ads & Marketing

LinkedIn Monthly Unique Visitors: LinkedIn's average monthly unique visitors has increased from around 31 million in 2009 to 84 million in 2011, and we estimate that it could continue to increase to around 290 million by the end of the Trefis forecast period. The unique visitors growth was more during the recessionary period and beyond. This is because the unemployment rate increased during recession and its after-effect were felt even after recession was over. Hence the unique visitors growth should slow down going forward, as the economy recovers leading to lower unemployment rate. However, if the growth continues, there could be an upside of around 10% to the Trefis price estimate for LinkedIn's stock if the number of unique visitors were to increase to around 380 million by the end of Trefis forecast period.

Page views per LinkedIn visitor: LinkedIn's page views per unique visitor has increased from around 24 per month in 2009 to 29 per month in 2011. We estimate that it could continue to increase to around 34 per month by the end of the Trefis forecast period. We believe that LinkedIn will continue to bring out features which will increase user engagement. For example, LinkedIn Polls functionality was brought so that if user answers these surveys, it will help increase page views per user. However, in the scenario in which the page views per user number reduces to around 26 by the end of the Trefis forecast period, there could be a downside of around 5% to the Trefis price estimate for LinkedIn's stock.

For additional details, select a driver above or select a division from the interactive Trefis split for LinkedIn at the top of the page.

The Trefis community is 95% bearish, 5% bullish
$95.64, MARKET PRICE, 8/1/12
$65.56, COMMUNITY AVERAGE
$43.99 www.trefis.com

From the preceding detail, you can see how granular the quantitative analysis becomes using so many metrics to value the stock. Stock analysts use these same types of financial models to quantify where LinkedIn is going. Any changes in growth announced by the company during the earnings report will be quickly incorporated into these quantitative models to come up with a new valuation for LinkedIn. Now we turn to demand and supply that actually determines the price of the stock.

WHAT THE CHARTS ARE SAYING ABOUT DEMAND AND SUPPLY

Once again, the planning premise is that all of the public information shown above about LNKD is already in the price showing on the charts below. In addition, there is also nonpublic information in the charts, where famous hedge funds have done their own proprietary analysis and have bought or sold accordingly before earnings. Price is going down before earnings, and this may be those hedge funds selling short, because their research or information they bought may indicate that LNKD will have a negative surprise. The long-term indicators on the chart are still positive despite the short-term selling.

The daily chart below shows the demand has slackened indicated by the 50-day moving average flattening out, but it has not yet turned down to test the 200-day, so no real supply showing up in the short-term trend. The long-term trend, the 200-day moving average is still up and positive. These are the two main indicators of demand based on price alone.

If you look back at the volume and price movements on May 17 and 18 on Exhibit 12.4, you will notice a big spike in volume, in red, and a significant drop in price in the red candlesticks. This is big supply, and the market knows what is creating it and taking price down. The picture of supply is quite vivid using both price and volume. Now look at the latest two days on the chart, August 1 and 2. The August 2 data is still in progress as the chart is time stamped 2:02 P.M. This supply is subtle, and the relatively low volume indicates the market does not know the cause of this supply. It is smart money. It could be selling short by someone who is betting price will go down. It could be telephone calls, first calls, by analysts to big paying clients. Or it could be just a lack of buyers waiting for earnings and sellers on balance who are nervous.

Now that you have a visual of what big supply and small supply looks like, let's look at some other signals. You can see that price broke below the 50-day moving average and is targeting a test of the 200-day, and that is a negative. Also price, on the last move up, did not test the old high at $120 but instead put a lower high in place at $110 and this is another negative (another sign of supply). The pattern of lower highs and lower lows is a bearish one.

EXHIBIT 12.4 LNKD, August 2, 2012, Daily
Source: StockCharts.com.

With this obvious visual from the price chart staring you in the face, let's turn to the less transparent, computer-generated signals on the daily chart (Exhibit 12.4). The PPO at the top of the chart, along with its histogram, shows the dropping momentum you can see visually on the price chart. This signal shows the stock is in a short-term selling cycle, which was off to a slow start a couple of weeks ago. No surprise that price is going down during a selling cycle where the worst is usually at the end of the cycle, yet another sign of supply before the earnings announcement.

At the bottom of the Exhibit 12.4 is the color-coded CMF, showing green above the horizontal line and red below. As you can see, it has dropped dramatically during the selling cycle and has just now gone into the red below the line. Another signal of supply confirming what you see visually on the chart just by looking at price and volume.

Now let's go to the weekly Exhibit 12.5 for more signals, ones that eliminate some of the day-to-day noise in price.

The weekly chart has only two positive signals on August 2, 2012, the day earnings are to be announced. First and foremost, the selling in the latest week has not broken below the 200-day moving average. Second, price has come down but on very light volume compared to the very high red bars of volume on the last selloff 13 weeks ago. The negatives, in addition to the big red candlestick for the latest week, are the breakdown in relative

EXHIBIT 12.5 LNKD, August 2, 2012, Weekly
Source: StockCharts.com.

strength at the bottom of the chart, and the momentum breakdown at the top of the chart as the PPO turns down and the histogram shows the start of back-to-back sell cycles, usually a bearish indicator. In other words, the histogram bars, instead of going above the line, started down again. The expected buy cycle never came, which is bearish.

Finally, let's look at the Point & Figure chart (Exhibit 12.6) to put some numbers to our strategies after earnings come out. Looking at the chart, you can pinpoint some support targets if the news is bad; in other words, how low is price going to go? Likewise, you can target the upside price resistance that will stop a move up if the earnings news is good.

In the Point & Figure chart (Exhibit 12.6) the latest drop in price before the earnings due after the close August 2, 2012, is indicated by the column of O's going down in red on the right side of the chart. The last O column stopped at $96, at support, but this current O column has broken below $96, a bearish break below support, identifying supply.

Now you have to go to the next previous O column and it ended at $93 support. But the current column of O's has broken below this support level, too! Price is in trouble, with supply having broken two support levels at $96 and $93. Price is now targeting the next support level at the bottom of the O's column that ends at $88.

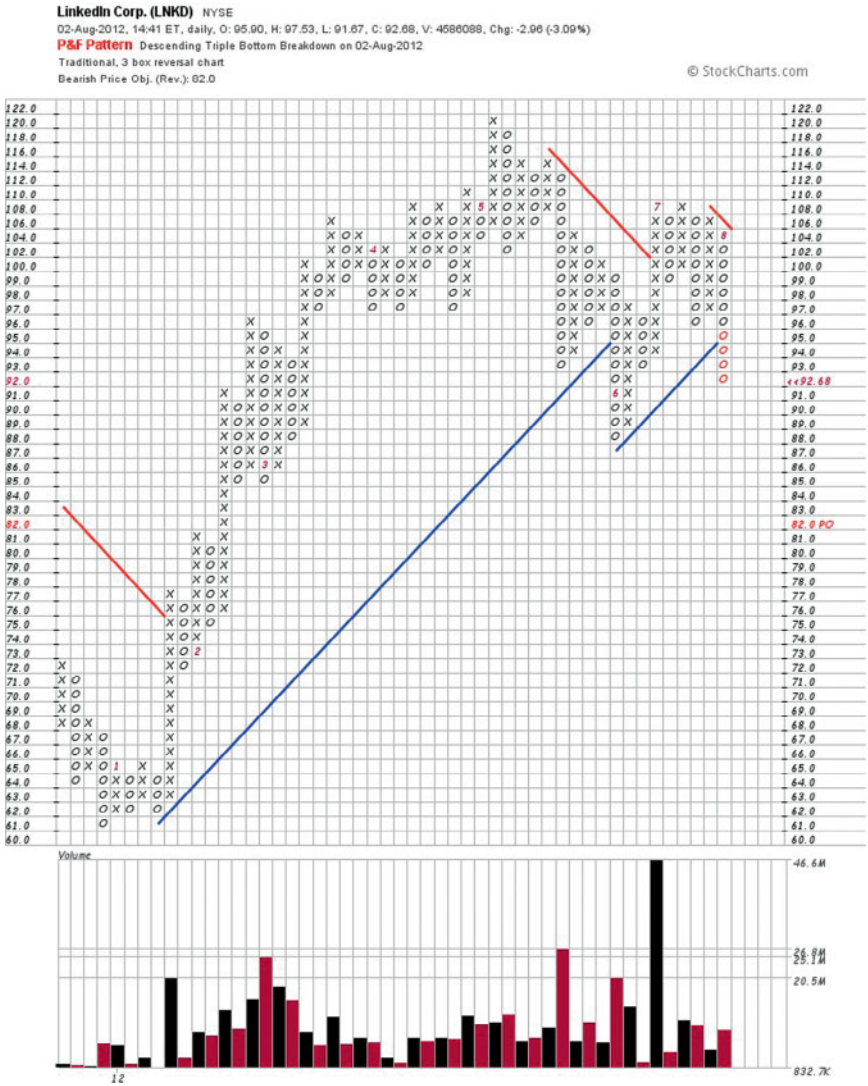

EXHIBIT 12.6 LNKD, August 2, 2012, Point & Figure
Source: StockCharts.com.

YOUR DECISION REQUIRED BEFORE LINKEDIN EARNINGS ARE ANNOUNCED

Take some time to formulate your analysis of this data before the earnings are announced after the close. You are not trying to predict what the earnings will be. Rather, the challenge is to have a strategy after the

earnings are announced. If the earnings are bad and price pulls back will you buy on weakness? If the earnings are good and price jumps up will you chase it to buy? If the news is bad, what price level do you think price will go down to, or if it is good, how high will price go? What are the downside support levels and the upside resistance levels showing on the Point & Figure chart?

However, the long-term 200-day signal is still positive. Would you consider good news and a bounce up positive confirmation of this long-term technical signal? If the news is bad and the 50-day moving average breaks below the 200-day would you sell? If the earnings are neither good nor bad, what would your strategy be?

Since the long-term relative strength signal at the bottom of the Exhibit 12.5 is negative (the most important technical indicator for portfolio managers), would you sell before earnings or wait until after earnings for confirmation of this negative signal? Good earnings could reverse this negative signal.

Now you are ready for the answer in the charts, which show exactly what happened to price after the earnings were announced.

ANSWERS TO THE LINKEDIN CASE STUDY

First, you go to the 5-day chart (Exhibit 12.7) to see the dramatic bounce up after the good earnings report is announced. It clearly shows the selling during the days before earnings and the dramatic bounce up after earnings. *The sellers were wrong.* Notice that just before the close, just before earnings are to be announced, price moves positively above the negative downtrends in the 20- and 50-minute trend lines on this chart. There is some last-minute buying before earnings. It could be some short covering buys or someone acting on illegal inside information.

In the weekly chart (Exhibit 12.8), you see confirmation of all the positive signals on the chart before earnings. The CMF was strongly in the green. The MACD was a fake-out sell cycle. The 200-day moving average was positive and is now confirmed. Relative strength, the most important signal, is confirmed positive, reverses its sell signal, and confirms LinkedIn as an outperformer versus the index.

The signals below the chart are also positive, except the MFI has not turned up yet. Since accumulation/distribution is a driver for the CMF, it is no surprise that this signal, like CMF, is positive. The 4-week (20-day) moving average had already moved above the 10-week (50-day) moving average on the chart before earnings. Most important, the candlestick after earnings formed a powerful hammer, a positive reversal signal, indicating higher prices to come and confirmed by an enormous green spike in

EXHIBIT 12.7 LNKD, August 3, 2012, 5-Day
Source: Yahoo.com.

volume. The hammer profile is shaped by the small white body and the long handle or shadow line. It is a well-recognized candlestick reversal pattern.

The Point & Figure chart (Exhibit 12.9) shows price testing well-established resistance at $108 after the earnings report. The positive hammer candlestick and volume on Exhibit 12.8 is signaling a break above $108 and a test of the next resistance level shown in Exhibit 12.9 at $114.

Finally, as my answer to the earnings announcement after the close on August 2, I wrote the following article titled "LinkedIn Is Not a Buy but It Beats Facebook," which appeared on MarketWatch.com at 5:00 A.M., before the open of trading on August 3, 2012. Trading opened at $105.66 and closed at $108.60, up 15 points from the previous close, a very strong buy signal.

LinkedIn has done everything Facebook was supposed to do and didn't. But is LNKD worth the price?

The earnings report was on target, and the forecast was even better; therefore, there seems to be no reason to sell it until it breaks its 200-day moving average or provides some other sell signal.

With its ridiculous valuation, it will take only one miss, one wrong step to send price tumbling down. That hasn't happened as a result of this earnings report and the price rose 5% after hours

EXHIBIT 12.8 LNKD, August 3, 2012, Weekly
Source: StockCharts.com.

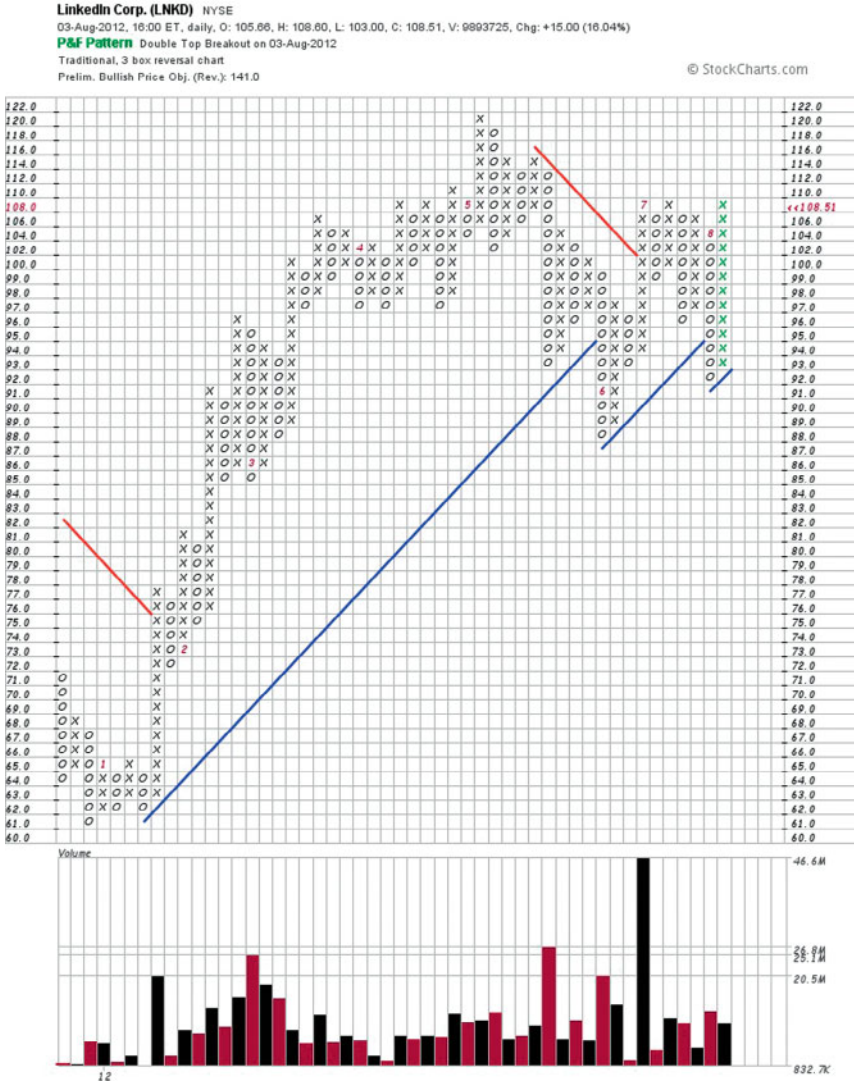

EXHIBIT 12.9 LNKD, August 3, 2012, after Earnings
Source: StockCharts.com.

Thursday to $100. According to the point-and-figure chart resistance is at $108 and that appears to be the target of this bounce up.

Before the earnings report there was some selling as analysts tweaked their earnings estimates to the downside but maintained 12-month targets. The high target is $150 and the mean target is $135, according to the Nasdaq. Using the $135 target and a 60% growth rate

would imply a current price of $84 and it seems LNKD was targeting that lower price before the good news in this earnings report.

This Finviz.com chart also shows the downtrend at $108 that LNKD needs to break above to signal that it has enough demand to retest the old high. That is asking a lot from this earnings report, with a mean target of only $135. If the bounce up isn't stopped at $108 it will probably be stopped at $120 for sure.

The analysts will tweak their earnings a little higher but not their targets, which are already very optimistic. The analysts are only showing nine buys out of 20 analysts according to the Nasdaq. They are not really enthusiastic at these prices.

The continued drop in price by Facebook and the weakness in the industry as well as the overall market aren't going to help move LNKD aggressively higher. There is no question that the institutions like this stock, but they have had a long time to accumulate their positions and are probably in no mood to chase price here.

The earnings have created some short-term demand that is taking price higher to test resistance at $108, but after this bounce up it will be back testing support again. Likely the institutions that are still buying will wait to buy on weakness again and not at these prices.

Before earnings, the Stockpickerusa.com valuation grid shows LNKD in the overvalued box four where most aggressive growth stocks appear. However, the valuation grid score of 4.3 is a poor one because point three indicates LNKD is in the bottom third of stocks when it comes to analyst forecasts.

The StockpickerUSA.com forecast models are obviously picking up on the number of analysts that don't have buys and the move to the downside of recent analyst estimates. This may change next week if analysts start upgrading their estimates substantially.

The total score by StockpickerUSA.com for LNKD, adjusted for the universe of growth stocks, is fifth decile for fundamentals, first decile for technicals and fifth decile for forecast data for a total score of 11 out of 30 where 30 is the worst score. StockpickerUSA.com won't rate LNKD a buy until forecast data improves.

Conclusion: The shorts are still too early for LinkedIn and are doing better with Facebook.

As you can see from the article, using the Point & Figure charts used throughout this book, I was able to point out the $108 target right after earnings were out and before the stock opened for trading. In the after-hours market, LinkedIn traded as high as $100 after the earnings announcement after the close. Then when trading opened the next morning, the stock started trading close to $106, fell back to $103 and went on to close at $108.

On Twitter, @tomlloyd12, I posted the following at $108:

@tomlloyd12, August 3rd, 12:05 P.M., $LNKD 108 retest resist, gap filling failed, on wkly chart hammer buy signal forming confirmed by volume, tgt 114,big broad mkt boost today.

The S&P 500 closed at 1,391, up 26 (1.9 percent) on the day. LinkedIn was up 15 points or 16 percent, outperforming the market enormously.

SUMMARY

This chapter enables you to see the birth of the earliest technical signals on a new stock after the first day of trading. The earliest signals are price and volume, the very basics of technical analysis. Eventually, all the signals appear on the daily chart: CMF; RSI; MFI; OBV; MACD; PPO; relative strength; 20-, 50-, and 200-day moving averages; candlesticks; gaps; and Point & Figure support and resistance levels.

The longest signal, the 200-minute moving average, appears on the intraday chart after 3 hours and 20 minutes. But on the daily chart, you will have to wait 200 days before you can use this important signal.

It will be weeks after the IPO before you can use the CMF or the MFI. After day 1, you will have OBV, but you have to wait for it to form a trend. The first day will also produce a candlestick on the chart which is an important indication of where price is going. Performance relative strength will quickly indicate supply and demand. After one week the candlestick on the weekly chart, a negative shooting star, warns that price is going down and it does go down for the next three weeks. The very informative Point & Figure chart is also available after day 1.

For our case study of LinkedIn, more than a year after its IPO, you can use all the technical signals from A to Z before their earnings report on August 2, 2012, to plan your strategy and tactics. After the earnings are announced, you can put your plan into action.

Successful Stock Signals for Traders and Portfolio Managers: Integrating Technical Analysis with Fundamentals to Improve Performance, Thomas K. Lloyd, Sr.

CHAPTER 13

Using the 200-Day Moving Average and Relative Strength to Rotate In and Out of Winners, with Starbucks Exhibits

Almost every portfolio manager looks at the 200-day moving average and relative strength versus the index. Some rotate in and out of long-term winners like Starbucks (SBUX) based on fundamental signals using a sector rotation strategy. Unfortunately, technical indicators are lagging signals and sometimes false signals. As you can see on the 20-year Exhibit 13.1 for Starbucks, it provided enormous returns compared to the index. These are the stocks that portfolio managers and investors love because they show how easy it is to trounce the index over time with well-known stocks. Also note that in Exhibit 13.1 every time the 200-day moving average was violated, it was an opportunity to buy on weakness for the long term. The only exception was the Great Recession of 2008–2009. Starbucks crashed worse than the market. But at the bottom it provided a great opportunity for bottom fishing because it went from $7 to a high of $62 between 2009 and 2012.

In this chapter, you will examine the signals that lead or run ahead of the 200-day downturn. Obviously, the 10-, 20-, and 50-day moving averages

EXHIBIT 13.1 SBUX, June 12, 2012, 20-Year
Source: Yahoo.com.

will lead, but frequently reverse, giving a false signal long term. Even the "death cross," when the 50-day drops below the 200-day on the chart, can reverse or "whipsaw."

The portfolio manager needs a reliable signal that will not reverse long term. That is why he uses the lagging signals that are more reliable but are costly because of poorer timing. As a result, the loss on a stock off its recent high in price can be substantial when the stock is sold. Portfolio managers always use fundamentals to make decisions, and if the fundamentals remain positive, they can afford to wait for very reliable technical signals.

On November 1, 2012, the fundamentals were still good for Starbucks before their positive surprise in earnings on November 2. According to Nasdaq.com, 17 of 26 analysts had buy ratings on Starbucks before the earnings surprise. With that kind of fundamental analyst support no portfolio manager would sell based solely on the technical sell signals flashed by the 200-day moving average and by performance relative strength versus the Standard & Poors (S&P) 500 Index. But these sell signals would certainly have raised concern among portfolio managers about Starbucks. The technical sell signals would put Starbucks on the portfolio manager's watch list. The portfolio manager's finger was ready on the sell trigger if earnings were bad.

Technical analysis signals help to improve the portfolio manager's timing such as buying on weakness and selling into strength. It improves their

fundamental buy and sell discipline. The challenge of this chapter is to identify the signals that reliably indicate where the 200-day moving average and relative strength signals are going long term. You will look at the signals we have discussed so far to identify those of value to the portfolio manager using the 200-day violation as a sell signal. The RSI, stochastic, MACD, OBV, and CMF are useful. Exponential moving averages may provide an edge. You want signals that are focused on price movements and signals that are based on volume movement. Combined, they give you the demand-and-supply profile you need using both price and volume separately.

PORTFOLIO MANAGERS CREATE PRICE TRENDS

Portfolio managers are the trendsetters in stock prices because they create significant demand and supply. The sell-side brokerage analysts can recommend stocks every day, but if portfolio managers don't act on those recommendations, very little of long-term significance is going to happen to that stock's price. Portfolio managers are the ones who buy millions of shares and move the market. They are smart enough to buy on weakness and sell into strength. It will take some time to research a stock after it comes to their attention because their analysts (the buy side) or the Wall Street brokerage analysts (the sell side) are recommending it. Brainless index funds also establish asinine trends such as taking bad stocks up with the good or in a bear market taking excellent stocks down with the bad. This is how index funds destroy efficient markets.

The "buck stops" with the portfolio manager. He is the one that will be fired for buying the wrong stocks. Analysts are paid for their in-depth knowledge of a company and can be wrong on their targets, earnings estimates, and recommendations for a stock. Everyone knows these are unpredictable so how can you fire an analyst for guessing wrong about future earnings when everyone knows it is just an educated guess.

Portfolio managers, however, have no such luxury. When they buy a stock, they are held accountable for that purchase. If they make too many wrong decisions and fail to beat the index or their benchmark, they will be fired. That is why the name of a portfolio manager is at the top of the mutual fund you buy. Don't bother giving your money to a mutual fund managed by some nameless entity. Then there is nobody you can hold accountable! Do you really think some anonymous investment team will work harder for you than someone who has his name and job on the line to manage your money? There is only one thing worse than an index fund, and that is a fund managed by someone without a name and reputation at risk.

WHAT DO PORTFOLIO MANAGERS LOOK AT?

First and foremost, portfolio managers look at fundamentals because they have a fiduciary responsibility to invest money in sound financial companies that are not frauds. Then comes the really difficult part of their job; namely, they must select companies that will outperform the index or the benchmark used to evaluate the portfolio manager's style of money management. The stocks the portfolio manager buys and holds need to do better than the S&P 500 Index if that is his benchmark. Usually, this is the benchmark for portfolio managers that are investing in very large companies, large "caps" or capitalization. Capitalization is determined by multiplying the number of shares issued by the price of the share. Those funds investing in small caps or midcaps will use a benchmark or index suitable for these types of stocks.

Hedge funds are for multimillionaire investors. These funds usually take higher risks for higher returns. Investors with large sums to deploy will have lawyers, accountants, and financial advisers making them aware of the higher risks they are taking for the higher returns available from hedge funds. Some hedge funds are truly hedge funds looking for lower risks, such as market neutral funds, which provide low risk and low returns. Their benchmark may be T-bills.

In general, hedge funds are not low-risk, but high-risk, high-return funds. Sometimes these funds blow up and go out of business because of the high risk. When that happens, some of these managers just close up shop and go out and start another hedge fund. You want to avoid these hedge fund operators. Your financial adviser will weed them out for you. Make sure your financial adviser is not being paid by the hedge fund. Do your own due diligence by having your lawyer and accountant double check what the adviser is telling you.

Both hedge fund portfolio managers and long-only mutual fund portfolio managers are looking for the best stock research that money can buy. Managers with the largest amount of money under management or with the largest amount of trading or turnover in their portfolio of stocks have the brokerage commission dollars to buy the very best research. Some of this research comes very close to being illegal insider information, and every year there is a headline case of someone trading on inside information and going to prison.

Almost all portfolio managers are hardworking, honest professionals trying to beat their benchmark using the best fundamental research available that they can afford to pay for and use. Their buy-side analysts are working diligently to pick out stocks with the best fundamentals and performance going forward. They have to work through the misinformation and the lack of information from companies. Companies like Facebook and Google sometimes refuse to forecast future data. Many times the future is

unknown and unpredictable but analysts and portfolio managers still have to make buy and sell decisions based on incomplete information. They use the best research available to make their decision, but all of the information, especially about the future, is never available. The portfolio manager faces tough challenges in making investment decisions for you and is paid accordingly.

Technical analysis is just another one of the tools they can use to improve their performance. Unfortunately, when the portfolio manager buys or sells millions of shares he has to contend with those who will front run his actions. He has to avoid moving the market with his large orders because it will hurt his performance. He is forced to buy on weakness and sell into strength, which may not give him the optimal prices that improve performance. He knows how difficult it is to pick tops and bottoms. He usually buys before bottoms and sells before tops, hurting his portfolio performance. Technical analysis can help portfolio managers do this better.

WHAT DO TRADERS LOOK AT?

In this chapter, we move from the long-term view of portfolio managers to the short-term view of traders. As you would expect, we are moving from monthly and weekly charts for portfolio managers to daily and 5-minute charts for traders. Traders are willing to sacrifice reliability for timing, just as portfolio managers are willing to do the reverse and sacrifice timing for reliability. Technical analysis is able to provide both types of signals to these very different participants in the market.

Portfolio managers have their own traders and trading desks that are interested in using these short-term technical signals. Just as portfolio managers have to use fundamentals, their traders have to use technical analysis. Portfolio managers may opt not to use technical analysis, but their traders and trading desk have no such option. They must use technical analysis to trade the market. The portfolio manager's trading desk has the challenge of executing trades of millions of shares without moving the market price and avoiding those who seek to know and front-run the portfolio manager's intention to buy or sell millions of shares.

MONTHLY CHART FOR PORTFOLIO MANAGERS

We will use Starbucks charts as a case study. The monthly chart (Exhibit 13.2) shows the long-term view and the long-term signals that portfolio managers are watching, in addition to the weekly and daily charts. The first two

EXHIBIT 13.2 SBUX, October 31, 2012, 10-Year, Monthly
Source: StockCharts.com.

signals you want to look at on this monthly chart are performance relative strength (relative to the S&P 500 Index) and the 6-month moving average, a proxy for the 200-day moving average.

It is easy to see the sell signal in Exhibit 13.2, where price has recently broken below the 6-month line in blue with a price label at $48.93 while price at $45.90 is below this 6-month exponential moving average (EMA). Likewise, at the bottom of the chart you can see that the SBUX: $SPY line has turned from an uptrend buy signal to a downtrend line sell signal. This line trending down indicates that Starbucks is underperforming the S&P 500 Index and is hurting the portfolio manager's performance on a monthly basis.

You can see it started underperforming in the second quarter of 2012. The question on October 31, 2012, is how many months will the portfolio manager accept this lack of performance? At what point will the fundamentals give him a sell signal? With these two sell signals on the chart the portfolio manager and analysts are busy determining whether this is just a temporary sell off or the start of a long-term downtrend. The pressure is on the fundamental analysts to prove their case to the portfolio manager that this is just a temporary setback because price was ahead of itself, was overbought, and was temporarily overvalued. Is price just coming down from lofty heights to fair valuation? Is this break below the 6-month moving average another opportunity to buy on weakness? Or is this the beginning of a long-term trend down?

Traders are not interested in the buy-and-hold status of Starbucks because they are busy selling it short because price is going down. Traders will stop selling it short when they see price holding at some support level because of good news and indications that bargain hunters may come in and start taking price back up. Then the traders will cover their short position and go long following the upward momentum just as they followed the downward momentum.

LEADING SELL SIGNALS

The most valuable signals in technical analysis are the leading signals, the ones that turn down well before the long-term sell signals are put in place on the chart. In Exhibit 13.2 you can see the overbought indicators were overbought for over a year and then turned down as price went down in the second quarter of 2012. The RSI was in the green above the overbought marker at 70 on the scale on the right of the chart. In the second quarter it turned down, heading from overbought to oversold. It may never reach oversold at scale marker 30 and may, instead, turn up half way down.

Likewise, the stochastic turned down from overbought above the 80 marker on the scale to the right, and started down in the second quarter. Now it has stopped its sharp descent and may turn up. Or it may continue down to oversold at the 20 marker on the scale, shown on the right of the signal. Both the stochastic and RSI gave an early warning in the second quarter that unusual supply was taking price down. Notice how long these signals were in overbought territory and therefore how important this signal was when it changed direction and headed down from overbought. These were dramatic and strong signals early on when price was at $54 in the second quarter. Price then dropped to a low of $42.87, so these signals were a leading indicator to the drop in price.

Both the stochastic and RSI are based on price. OBV uses both volume and price. As you can see in Exhibit 13.2, OBV just violated the strong uptrend that was in place, but it does not yet show an obvious downtrend, as you see in the relative strength, RSI, and stochastic. If you look back at how OBV dropped from 2007 to 2009 as price dropped from $39 to $7, you will see that OBV does not have a similar downtrend pattern yet.

There are two other positive signals on the chart. The CMF is still strongly in the green despite all the sell signals and despite the selling cycle shown as the MACD bars go below the horizontal. The directional signal (ADX plus D1 and minus D1) is still positive but very close to turning negative when the red minus D1 line moves above the positive green plus D1 line. Notice that when this happened last time in the first quarter of 2007, price dropped from $27 to $7 in early 2009. In the third quarter of 2009, the directional signal crossed over positive at around $17 and stayed positive all the way up to $62 and is still positive but very close to turning negative again at $45.

What are these mixed signals telling the portfolio manager?

- The violation of the 6-month exponential moving average puts Starbucks on a sell watch list.
- The sell signal downtrend in relative strength identifies Starbucks as an underperformer hurting portfolio performance. If this continues, it must be sold.
- The CMF and plus D1 and minus D1 sell signals are not in place yet. These positive signals are in sync with the fundamental buy signals still in place.
- Wait for the MACD bars to go above the line in a buy cycle. Confirm that the sell signals are still in place. Sell into the strength of the next MACD buy cycle.
- If the MACD bars go up to the horizontal, fail to break above, and instead start going down again, sell Starbucks.

- Or if the next MACD buy cycle reverses the sell signals, continue to hold Starbucks. The positive CMF signal is supporting this possibility in Exhibit 13.2.
- The weight of evidence for negative sell signals will override one remaining positive signal that is lagging.

WHAT WILL THE WEEKLY CHART DO FOR THE PORTFOLIO MANAGER?

The weekly chart (Exhibit 13.3) will give the portfolio manager advanced warning on what will happen to the signals on the long-term monthly chart. You will look on the weekly chart for signs that the ADX plus D1 and minus D1 will turn negative on the monthly chart. You also want to determine if Starbucks will continue to underperform on the monthly chart. If the next MACD buying cycle is going to correct any of the existing sell signals, you should be able to detect signs of that improvement in the weekly chart. That is why you go from the monthly (Exhibit 13.2) to the weekly (Exhibit 13.3).

The weekly chart shows a dramatic jump in price in the latest week due to the good earnings report on Friday, November 2, 2012. This is a short-term buy signal in both price and volume. As a result, the sell signals on the 200-day moving average and relative strength versus the $SPY (RS) are corrected for the short-term weekly chart. Thus, there is now some evidence for correcting the sell signals on the long-term monthly chart. The CMF on the monthly (Exhibit 13.2) may have correctly guided you away from a false signal in the 200-day and in relative strength, which indicated that Starbucks was underperforming the index. The CMF on the monthly (Exhibit 13.2) is the type of lagging reliable signal that portfolio managers want. However, notice that on the shorter-term weekly (Exhibit 13.3), this same signal was in the red.

Since the CMF was obviously still positive and lagging the negative 6-month moving average and the relative strength signals on the monthly (Exhibit 13.2), it prevented an untimely selling of Starbucks based on this one technical signal confirming positive fundamentals. I know of no portfolio manager who would use technical signals as the only basis to make a buy or sell decision. Also, the directional plus D1 and minus D1 had not flashed a sell signal on the monthly (Exhibit 13.2). So these two positive laggard signals would have prevented the portfolio manager from selling. Without confirmation of the 6-month moving average and relative strength sell signals during the next MACD buy cycle with bars moving above the horizontal, the portfolio manager will go with his fundamental

EXHIBIT 13.3 SBUX, November 2, 2012, Weekly
Source: StockCharts.com.

buy signals and continue to hold Starbucks. However, if the sell signals are still on the monthly chart when the MACD tops out above the horizontal and the bars start decreasing, the portfolio manager faces a dilemma, and this is the reason he is paid so much money. He or she must find out why other market participants are selling despite good fundamentals. The portfolio manager does not have the luxury of just relying on fundamentals.

The weekly chart with the latest buy signals shown in Exhibit 13.3 will encourage the portfolio manager using technical signals as part of his sell discipline to wait for the MACD buy cycle. It will probably develop from this buy signal on the weekly chart caused by a positive surprise in earnings. It is possible that the excitement over earnings will not last and the correction of the sell signals may improve only temporarily and never change the signals on the monthly chart.

For the time being, the improvement in the weekly chart due to the positive surprise in the earnings report will trigger the start of a buy cycle; thus, a blue up arrow is shown for the MACD signal in Exhibit 13.3. You should see that in the MACD and depending on the strength of the buy cycle, you could see the sell signals showing on the monthly (Exhibit 13.2) reversed. With 17 of 26 analysts maintaining a buy rating for Starbucks, there is probably no fundamental reason for portfolio managers to sell. Without a fundamental reason for selling, portfolio managers will ignore the technical sell signals. They will focus on the strong CMF signal, which was strongly in the green in Exhibit 13.2, dated before the positive earnings surprise. The positive earnings report should keep this money flow signal in the green and perhaps turn some other signals positive.

POSITIVE UP ARROWS IN EXHIBIT 13.3

Notice all of the positive blue colored up arrows now annotated on the weekly (Exhibit 13.3) after the good earnings report. The signals are turning up. The short-term selling cycle is over and a buying cycle is under way. Hindsight tells you we just missed a short-term opportunity to buy on weakness. The signals tell you price is going higher.

In addition to the positive CMF money flow signal on the monthly (Exhibit 13.2), this weekly (Exhibit 13.3) shows a positive candlestick signal, a week ahead of the surprise in earnings. The doji signal in the candlestick looks like a star cross. It means the opening and closing price for the week before earnings were almost equal. Since price was going down in the weeks before this signal, it is a sign that the sellers are exhausted. Sellers and buyers are in equilibrium. Since price was in a downtrend, when

this signal appears, it could mean that price will reverse and start testing the upside. It does not always work. It is just another signal to be included in tilting the weight of evidence one way or the other. If the sellers knew earnings were going to be bad, this signal would not have appeared. As it is neither the buyers nor sellers were sure of earnings the week before. They were in balance. Therefore, Exhibit 13.3 is indicating that Exhibit 13.2 should improve.

HOW DO YOU TRADE STARBUCKS SHORT TERM?

Traders will want to glance at the daily (Exhibit 13.4) before turning to the 3-day (Exhibit 13.5) and then using the 5-minute (Exhibit 13.6) to trade the minute-by-minute battle between supply and demand. As you can see in Exhibit 13.4 just by looking at price and volume, there is an enormous gap-up in price, with a spike in volume about three times normal on November 2, 2012. There is no question about this buy signal, and there is no question that the sellers in the market were wrong. Traders love surprises because they make most of their money when the market was wrong on a stock. When the trader goes in on Monday morning, he will be looking for continued testing of $52 resistance and pullbacks in price to fill part of the gap-up. Based on what he sees in the real-time chart, he will short at $52 and buy pullbacks to $49-50.

In addition to the obvious buy signals in price and volume, Exhibit 13.4 shows blue up arrows as all of these daily signals turn from negative to positive. The only exception is the lagging CMF at the top of the chart. It was deeply in the red, showing how wrong the sellers were. Notice a few days before earnings that CMF starts improving and moving up from deeply in the red. It obviously picked up the exhaustion in selling but has not recorded the gap-up in buying. Unfortunately, the CMF methodology misses these important gaps up or down. But the weight of evidence of the other positive signals offsets the failure of CMF to jump up into the green based on this enormous buy signal.

Notice that price breaks above the 200-day moving average. More important to the trader are the 20- and 50-day moving averages, which turn up in direction. The 50-day is still below the 200-day and that death cross needs to be corrected. Traders are contrarians and they will be looking for opportunities to sell short this sharp move up. After the gap up on November 2, the candlestick formation on the close is a bearish shooting star. It shows a long wick or shadow up to $52 and a short body closing at $51. This usually means the buyers were exhausted at resistance $52 and price is going down to test support. On the open Monday, the price might

jump up to $52 if there are margin calls on the shorts, and those margin calls result in automatic buying on the open to cover the shorts that had margin calls. Traders will short this buying on the open knowing that once the shorts are covered by the margin call buying, the price will probably drop to retest support and make another attempt to fill part of the gap up in price.

Traders know that it will take some time to break above $52 resistance. Even after price moves through this resistance level, it will probably remain trading in the $52 to $55 resistance range for some time to come. It will take more good news in next quarter's earnings to move past $55 and attempt a move to the old high at $62. Right now, traders are only interested in shorting at $52 and buying at some unknown support level, probably $49.

Notice that the stochastic and the RSI are moving up to overbought in Exhibit 13.4. Traders will keep this upward momentum in mind and have a bias to buying the pullbacks in Starbucks. Short term, there could be consistent downside pressure to fill the 4-point gap-up in price. Traders like to short the very short-term overbought condition created by the gap-up and panic buying on the unexpected good news from Starbucks latest earnings. The pop up in Starbucks price is a knee-jerk reaction to the good earnings report. Portfolio managers are the ones that determine where price is going on a trend basis. Traders determine where it is going on a knee-jerk basis.

The larger question that remains unanswered is: will this good news by Starbucks stop the strategic selling by portfolio managers? If strategically a large portfolio manager such as Fidelity has decided to rotate out of Starbucks, then this blip in earnings is not going to stop the selling. The selling will stop when a firm like Fidelity is out of their position. Those portfolio managers who have decided to rotate out of Starbucks will just use this earnings report to sell into strength. Once a portfolio manager has decided to sell a stock, he will rarely reverse that decision because it is a strategic decision and a positive surprise, unless it is earth shattering, will not stop a strategic decision to sell.

The other part of the equation is how much new demand will be created by this surprise. Is it big enough to encourage new money managers to start buying? Will it encourage existing holders of Starbucks to buy more? These questions are yet to be answered by the chart. If sell-side analysts start increasing the 12-month targets and 9 analysts out of 26 that don't have buys switch to a buy recommendation, then you may see much more demand come in for Starbucks. Traders and portfolio managers will be watching for this fundamental upgrade. The chart will tell you if it is really a strategic major event for Starbucks by breaking above $52 to $55 resistance.

EXHIBIT 13.4 SBUX, November 2, 2012, Daily
Source: StockCharts.com.

DAY TRADING STARBUCKS AFTER GOOD EARNINGS

The 3-day daily (Exhibit 13.5) shows the dramatic 4-point jump to almost $51 after the earnings surprise. The volume was three times normal and a strong confirmation of this short-term buy signal in price. Traders will be very interested in playing this going forward because Starbucks was extremely oversold and had important sell signals in place that were obviously wrong. Short covering may be taking price up. Based on the monthly, weekly, and daily chart you are in a perfect position to map out a trading strategy for the coming days.

EXHIBIT 13.5 SBUX, November 2, 2012, 3-Day
Source: Yahoo.com.

Obviously, some of the 4-point move up on enormous volume was caused by short covering. It is possible that on the next trading day which is Monday, November 5, 2012, that there will be an effort to take price down to fill part of the 4-point gap-up in price. This depends on the sellers who took price down since the second quarter. This earnings report is not going to change their minds about selling. The selling has gone on for so long that the sellers may have been exhausted by the very high volume of buying after earnings on Friday, November 2. If that is the case, then price will keep moving up without filling the gap-up. However, if the sellers were not exhausted by the three times normal volume, then the gap will be filled to some extent on Monday, possibly 50 percent or maybe less. Traders on Monday will be looking for any kind of residual selling left in Starbucks. If they don't see the sellers coming back, they will go long and play price to the upside.

Traders are contrarian, so if the buyers take Starbucks up on the open Monday, they will short the move up. Once the opening buyers are filled, they will wait for price to come down to cover their short. This earnings report is not good enough to bring any enormous buying by portfolio managers. All this earnings report will do is convince portfolio managers to "stand pat" with their holdings in Starbucks. The consensus target is $58 and the high target is $64. At $51, a 20 percent increase over 12 months will take Starbucks to $61. It doesn't look as if there is much room left to the upside. It quickly retreated from the last high of $61.57, so price is not going to revisit that level short term. There is strong resistance at $55. On the Point & Figure (Exhibit 13.6), you can see resistance at $52 and then $55.

Based on the preceding planning premises, it would seem that a good proactive trading strategy would be to short any opening move up on Monday, November 5, and continue to short resistance at $52. Look for pullbacks to test the 200-day at $49 shown on the daily (Exhibit 13.4).

On the 1-day (Exhibit 13.7), the 200-minute moving average is at $48. On any attempt to fill the 4-point gap-up, a usual 50 percent retracement or 2 points would take price down to $49, and possibly the 200-minute at $48.

Exhibit 13.8 is an example of what the day trader will be looking at on Monday, November 5, 2012, when Starbucks opens for trading. This chart shows the opening on November 1, and it shows some of the tools the day trader will be using. The first thing the day trader will be using is price and volume on a trade-by-trade basis. The candlestick will be trading in seconds, forming before your eyes, and finally put in place as a 1-, 3-, or 5-minute candlestick; however the day trader wants to select. Notice on this chart that price begins to bounce up from the 50-minute trend line for a nice bounce up. See the doji, starlike candlestick, which is a sign of price reversal to the upside. The MACD and stochastic are in sync with this

EXHIBIT 13.6 SBUX, November 2, 2012, Point & Figure
Source: StockCharts.com.

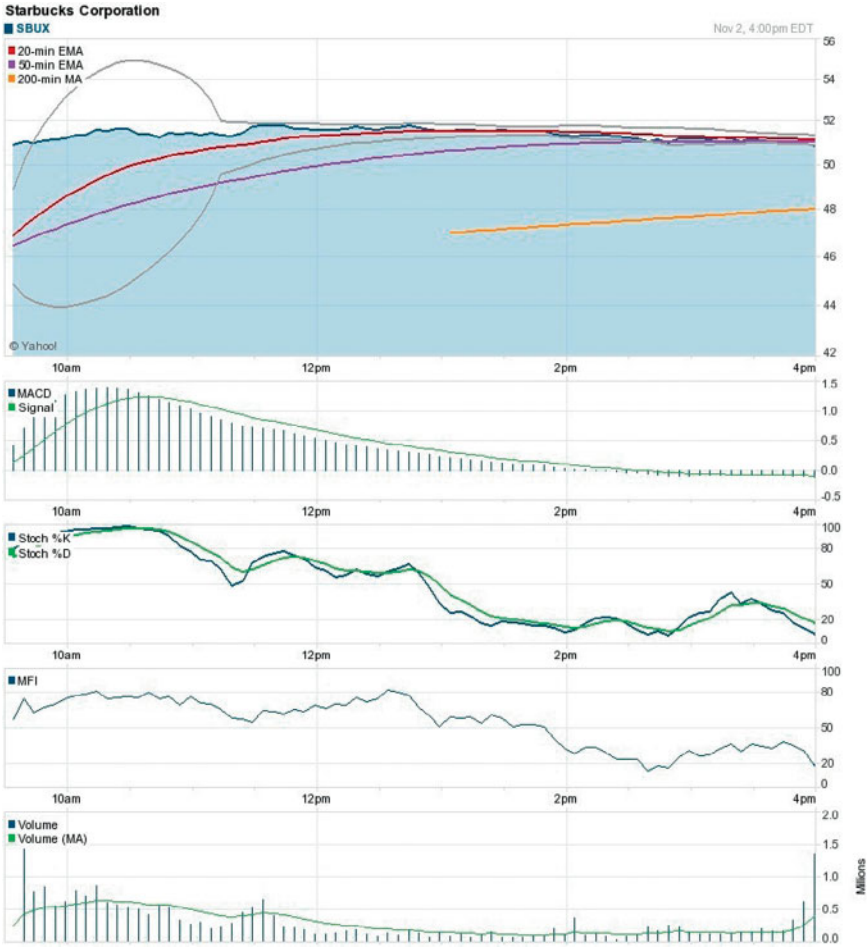

EXHIBIT 13.7 SBUX, November 2, 2012, Intraday
Source: Yahoo.com.

move up, confirming that demand is taking price up. Then both of these signals peak and turn down, signaling that it is time to go short. The last candlestick shows price testing the 20-minute uptrend. The MACD, MFI, and stochastic are indicating it will probably not hold as a support level and price will probably go down to test the 50-minute uptrend.

Notice that price is surrounded by two wide bands, which are Bollinger bands, and they are in an uptrend. Price ran along the top Bollinger band and then failed and broke away. This was the first indication of price weakness. Also look at volume dropping as price comes down, whereas at the

EXHIBIT 13.8 SBUX, Day-Trading Signals, November 1, 2012
Source: Yahoo.com.

beginning of the day heavy volume took price up. Finally, you can see that this chart does not have prices on the chart on the right-hand scale but is measuring the percentage move in price up or down. Likewise, there is an SPY line on the chart measuring the move of the market up and down. You want to know price movement relative to the market. If price is moving up better than the market, then this is a sign of strong demand internally, not just from the market move up. In this case, the green SPY line is below the prices for Starbucks, indicating that Starbucks is up more than the percentage for the market, a sign of strong demand for Starbucks.

SUMMARY

In this chapter, we started with the long-term strategic overview of the portfolio manager and the charts and signals that he would use. Specifically, the signals were performance relative strength and the 200-day moving average. In using the weight-of-evidence approach to decision making, we used other signals to enhance these two important and widely used signals. These signals included directional movement plus D1 and minus D1, RSI, MFI, MACD, and CMF. Using long-term monthly and weekly charts for the portfolio manager and daily and minute-by-minute charts for the day trader, we showed how the signals work for investing or trading using Starbucks (SBUX) as a case study.

Successful Stock Signals for Traders and Portfolio Managers: Integrating Technical Analysis with Fundamentals to Improve Performance, Thomas K. Lloyd, Sr.

CHAPTER 14

Technical Signals for Your Buy and Sell Discipline, from Stochastics to the 200-Day Moving Average, with Chipotle Mexican Grill Exhibits

We already know that many investors use reliable signals such as the 200-day moving average and relative strength to trigger a buy or sell discipline in conjunction with fundamentals. Can we improve upon those signals for the small investor and the portfolio manager? The small investor may be using a simplistic sell discipline, such as, selling when price drops 10 to 15 percent below the most recent high. The domino effect of technical analysis signals provides a much more sophisticated approach than simply using one signal. Some refer to it as the *weight of evidence.* We will move through all the signals for your buy and sell discipline, from stochastics to the 200-day moving average, as the weight of evidence tips the scale from positive to negative, using Chipotle Mexican Grill (CMG) as the case study.

Investors and portfolio managers are not too concerned about buy signals. Every portfolio manager usually has developed some strategy for buying that is fundamentally driven. The two extremes are bottom fishing

and momentum investing. Sell-side analysts are constantly issuing buy recommendations so there is never any shortage of buy candidates. Therefore, portfolio managers are more interested in a sell discipline that may improve all the money they leave on the table as a result of premature selling of a stock that is "overvalued" in their fundamental work. They sell based on a fundamental sell discipline and wonder why price keeps going up. Price keeps going up because of demand and buyers who ignore the fact that a stock is fundamentally overvalued. This can go on for some time before overvaluation leads to a crash in price.

Technical analysis measures this demand and can guide a portfolio manager to higher prices and the top before he sells. Technical analysis is perfect for buying on weakness and selling into strength. This is the expertise that portfolio managers need if they are to improve substantially their buy and sell points on any stock. That is what improves their performance, not just picking good stocks. Most portfolio managers buy on weakness and sell into strength, but unfortunately, they may not use technical analysis to optimize these decisions. As a result, they often buy too early, not close to the bottom and sell too soon, not even close to the market top for stock prices.

For the sell discipline, we will look at Chipotle Mexican Grill as our case study. Use all our signals, A to Z, to show the domino effect of signals changing, until the weight of evidence shows a buy or sell before the 200-day lagging signal. We go from the stochastics and MACD to the 200-day and the death cross when the 50-day breaks below the 200-day.

We go from the daily chart to the weekly and monthly chart to determine what signals work. This will be the reverse of the method used in the last chapter because it is the way most people do it when looking at a stock from a technical point of view. Unfortunately, many do not use the long-term charts and the long-term signals to improve their decision making. Here, we will encourage everyone to complete these last steps.

CMG was a "hot" growth stock that was extremely overvalued and on the fundamental valuation sell watch list of every growth portfolio manager. That is the reason price was dropping and most fundamentalists were out of it long before the top. David Einhorn focused attention on this valuation problem in October 2012 when it was well off the top and the stock promptly dropped some more.

Let's turn to the short-term trader's 5-day chart on November 6, 2012, just to see where CMG is trading and see how the traders are viewing it each day. You may be a hedge fund looking to short this stock expecting it to go still lower because of the powerful technical sell signals on the charts that confirm the fundamental valuation sell signals. In contrast, if you are a

bottom fisher, you may be looking for the bottom where valuation is once again relatively reasonable and you want to bottom fish the bargain price. Price has dropped 38 percent from its high. Is it now oversold and fairly valued, or undervalued?

Exhibit 14.1 shows the typical 5-day chart you would pull up to compare price to the 5-day trends in the 50- and 200-minute trend lines. You may want to look at the overbought and oversold oscillators at the bottom of the chart to identify where the traders are selling into strength or buying on weakness. If you plan on buying or selling this week, this chart is a good starting point. More than likely, you have not made a decision. From this starting point you will go to the other longer term charts to formulate your strategy and tactics for CMG going forward and look to synchronize technical signals with fundamentals that drive decision making by portfolio managers.

PRICE JUMPS ON THE ANALYST UPGRADE

On the Exhibit 14.1 dated November 6, 2012, you will immediately notice the big jump in price. Bank of America-Merrill Lynch upgraded CMG from a hold to a buy with a target of $320. Price quickly jumped 15 points to $280. A quick check of Nasdaq.com shows that CMG had only 4 out of 22 analysts with a buy rating. So this upgrade has this analyst joining the minority. When an important analyst risks his reputation and paycheck by joining the minority he has my undivided attention. He will also have the day trader's attention. Day traders look for news like this before the market opens and trade these stocks sometimes before the open. They know the news is going to move price and they are going to trade that momentum as long as it lasts. When demand is exhausted they will sell short again for the ride down in price.

On November 6, 2012, the mean analyst target is $300. Of the 14 analysts recently changing earnings estimates, 12 analysts bearishly downgraded according to nasdaq.com. The shorts amount to 3.6 days volume of trading and 13 percent of the float or the total stock available for trading as indicated by Yahoo.com statistics. Thus, this jump in price is probably caused by some shorts covering, creating a minor short squeeze. As hedge funds look at Exhibit 14.1 they would be aware of all of this. They have to decide whether to continue to play the bounce up or wait for the top and short it again. Day traders will be buying every pullback and playing the upside momentum caused by the analyst upgrade and the shorts scrambling to cover by panic buying.

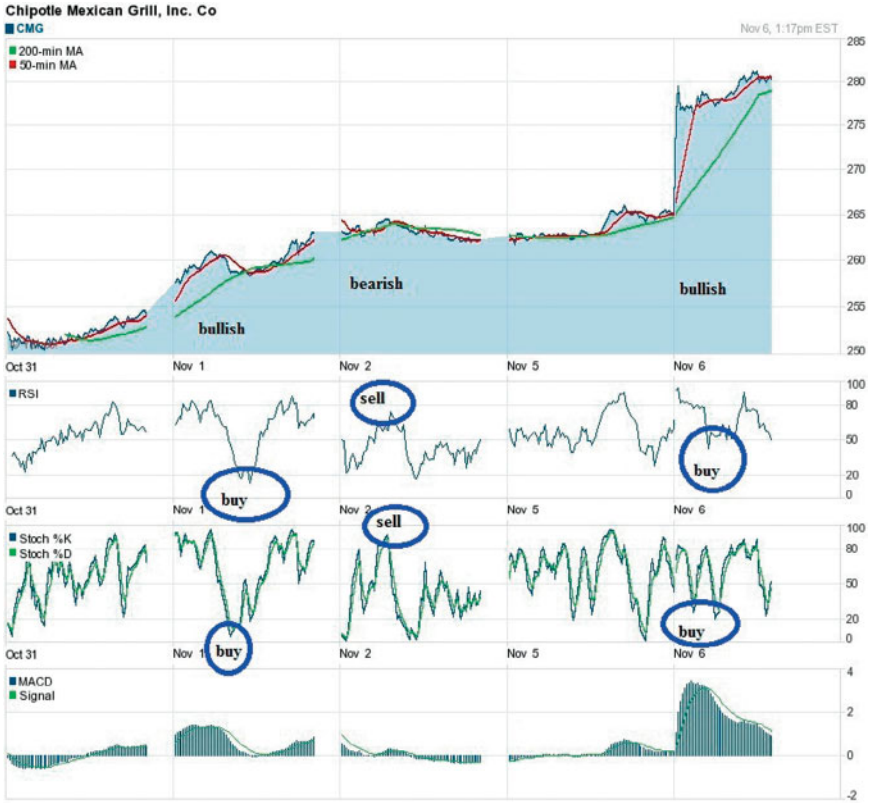

EXHIBIT 14.1 CMG, November 6, 2012, 1:17 P.M. EST
Source: Yahoo.com.

DAY TRADING THE NEWS

On November 6, 2012, the day traders had to buy on the open to catch some of the big move up from the $271 open which was followed by a quick move to $280. Price moved up so fast it was tough to catch the trade. Then the trader's strategy was to buy any pullback. You can see on Exhibit 14.1 that on November 6 there is a pullback to test the 50-minute uptrend shown in red. The MACD and RSI drop to oversold for the "buy" we indicate under these signals on the chart. It is a buy on weakness strategy that traders and market makers love to play.

Prior to November 6 we indicate on the Exhibit 14.1 where the 50- and 200-minute trend would have the traders leaning either bearish or bullish

on the day. On the bullish trend days, the traders would favor buying the oversold indicators indicated by the notation "buy" on the chart. Likewise on the bearish day, traders would be inclined to go short on the overbought indicators and we show the term *sell* on the chart as the signal becomes overbought.

The final decision to buy or sell is made by the day trader watching the tick by tick formation of the 1-minute candlestick and the movement of volume telling him instantaneously where demand and supply are going. He will also see very short-term support and resistance levels forming on the minute-by-minute chart. These support and resistance signals become important trading triggers for the day trader.

The day trader is using the same candlestick, volume, support and resistance rules we use when we are looking at daily charts. He is watching them form quickly in real time on his chart in very short time frames of one, three, or five minutes. He is ready to reverse his trade in an instant and is therefore not too concerned about the reliability of any one signal. He is using his brain and experience to trade and reading the tape ahead of any technical signals. He has to be a tape reader, and the technical signals confirm what he is seeing. If they don't confirm what he is seeing in supply and demand as indicated by candlesticks, price and volume or support and resistance, he will ignore the technical signals.

TRADING SYSTEMS

Other day traders use robot-like trading systems on their screens. They just monitor the signals and follow them like a robot. The one good thing about using a trading system is it takes all the emotion out of trading. It helps your ego, too, because you are not responsible for making the error, the trading system is. Many traders are just babysitting trading systems and they don't need to learn how to read volume or price movements. They just supervise the trading system and make sure it is executing the orders generated by the system, or they are manually executing the orders generated by the trading system.

There are many free trading seminars available where they train you in their trading system, and assign a coach to help you start trading. For some people this works, but the vast majority of professional day traders are using their brains and experience to read the tape and trade. The reason they don't use a trading system is that they want buy and sell signals that are front running the trading system's signals. They will look at technical signals for confirmation of what they are seeing on the tape and to "game" those that are using technical signals.

One very smart and experienced professional trader I knew had a very interesting hedging system. He used a computer system to pick 25 stocks to go long on Monday and hedged these picks with 25 stocks to go short. I use a system that can do the same thing.

He sat in front of his computer all day long just babysitting these 50 open positions. If one blew up, he would quickly trade out of that one position. He had a seat on the New York Stock Exchange so transaction costs were minimal. At the end of the week he closed all of his positions and went home to enjoy the weekend with not a care in the world. Pity the poor portfolio manager who has open positions 24/7 and is constantly concerned about the market, a stock or an industry blowing up.

TRADING INFORMATION

Those who have access to order flow data have no need of technical signals because they have information before it hits the tape. You can be sure they are watching technical signals on their screens. Technical signals predict what traders are going to do using these signals. Knowing which way "the crowd" is going is very profitable insight. Professional traders and computerized trading programs want to front run or trade ahead of the crowd.

Now let's go to the intraday, 5-minute Exhibit 14.2 and examine the buy signals day traders could have used to trade the news on CMG on November 6, 2012.

DAY-TRADING BUY SIGNALS

In Exhibit 14.2 you can see what happened throughout the day for CMG after the blockbuster analyst announcement upgrading the stock. Most of the money for day trading was done on the open or right after. Later, there was an opportunity to make a 3-point swing from $278 to $281. The MACD shows the really negative divergence as price stays high, but the MACD shows continued weakness.

Day-trading buy signals are identified with "up" blue arrows on Exhibit 14.2. The day trader would be using much shorter time intervals than shown on this chart, but the buy signals identified on this chart would not be ignored by any day trader. Using 1- or 3-minute charts would allow the day trader to see these buy signals developing earlier than shown on the chart. This chart has the advantage of all lagging indicators. These signals will be more reliable than the shorter interval signals the day trader might be using. These slower signals may keep the novice day trader out

EXHIBIT 14.2 CMG, Day Trading, November 6, 2012
Source: Yahoo.com.

of trouble. Slower signals such as these lower the risk and also lower the returns in day trading.

Don't forget some day traders would have closed up shop for the day if they caught the opening trade, which was very lucrative going from $271 to $280 in the first 10 minutes. See the first two long white candlesticks supported by enormous volume and all signals on the Exhibit 14.2 moving up.

As you can see the blue arrows for each signal are in sync with price movement to the upside. The oversold oscillators start moving up for the buy signal we also identified in Exhibit 14.1. These signals are further

supported by increasing volume taking price up. The white candlesticks also show the demand moving price.

The volume for the day was just above normal volume. What does this tell us? Light volume and big price movement is an indication of short covering. If volume had hit three times normal volume, you would have a robust buy signal indicating that some portfolio managers were buying. As it is, you have a trader's "knee-jerk" price movement up with no sign yet that portfolio managers are going to jump in and change the long-term trend of CMG. What is the long-term trend for CMG?

SELL SIGNALS ON THE SHORT-TERM DAILY CHART

Exhibit 14.3 dated November 6, 2012, is the daily chart and you can see all of our usual signals are negative. The long-term 200-day moving average has rounded over from an uptrend to a downtrend. The death cross was established when the 50-day drops below the 200-day; it is entrenched because the 50-day is still heading down. The Chaikin Money Flow (CMF) is deeply in the red but recently showing some improvement, just turning green. On-balance volume (OBV) and Relative Strength (CMG: $SPY) are in downtrends.

Price has dropped from a high of $442 to a low of $234 (a 47 percent drop) before this current bounce up to $281. This move up is a good example of a "gap down" in price being filled. Notice on Exhibit 14.3 that price gapped down from $280 to $250 on October 19, 2012. Then, price started a bounce up in an attempt to fill some of this gap down in price. The upgrade by the analyst was the news needed to completely fill this gap down and price returned to the breakdown point at $280.

If you go back to July 20 on the chart you will see a major gap down sell signal from $405 to $330 with a spike in volume. We identify this major sell signal with the blue arrow on the chart. This gap down is only partially filled when price bounces back up to $352 on September 17, a bearish dead cat bounce failing to reach $405. Price then drops to $280 to retest support. You can see that the support level fails at $280 and price goes lower to $234.

BUYING AT THE BOTTOM

The $280 violated support level becomes a resistance level instead of a support level. It is no surprise on the bounce up that the bounce is stopped at this resistance level. Just like last time the price turns down and will probably retest support at $234. It will be bullish if it establishes a higher

EXHIBIT 14.3 CMG, November 6, 2012, Daily
Source: StockCharts.com.

bottom. The fact that this time it completely retraced the gap down is also slightly bullish. Last time, it only retraced part of the gap down and you can see that was a bearish signal. Volume shows that there is no spike in demand on the bounce up to fill the gap. Volume is not confirming this bounce up. There is no buy signal yet in volume or price. You needed to see a spike in volume and a strong move up above resistance at $280 for a buy signal. The best you can conclude from this is that the retest of the bottom may hold and the bottom may be in place at $234. But you have to wait for that test before buying on weakness. See how long the drop from $352 retested $280 before $280 failed and price went down to a new bottom at $234. It took two weeks before price broke below $280 and headed down looking for a new bottom.

The signals will tell you when to buy the bottom. First, you will get a buy signal and then the pullback from that buy signal will be the bottom to buy. Expect that bottom to be higher than $234 if, indeed, $234 turns out to be the final bottom.

CHANGE IN CHARACTER FROM BULL TO BEAR

Exhibit 14.4 is the weekly chart showing the dramatic "change in character" from bull to bear in CMG. Every signal turns bearish and the weight of evidence on the supply side is overwhelming. It is no surprise to anyone that price can do nothing but go down for the count, whether you use Elliott waves or Fibonacci retracement levels to count down as shown on Exhibit 14.5. For the portfolio manager who has his finger on the sell trigger because of overvalued fundamentals, the RSI and the plus D1 peak identify the top for him in April 2012 near the R2 price label $434.46 and it is time to pull the trigger. Many portfolio managers do just that and it changes the trend from bull to bear.

SELLING AT THE TOP

In addition, if you turn to the monthly Exhibit 14.6, which has very reliable candlestick signals because of the monthly duration, you will see two monthly topping signals that spelled "top" two months in a row near $420 in April and May 2012. You can see price hitting the high of $442.40 in April but at the same time forming the negative and reversal doji signal, which looks like a star cross and both the opening and closing price are close to equal forming the cross. For two months back to back, there are candlestick topping signals with the shadow or the line below the cross

EXHIBIT 14.4 CMG, November 6, 2012, Weekly
Source: StockCharts.com.

Note: All of the bold blue arrows pointed to the right identify supply signals.

testing the downside prices, a signal that the bulls are exhausted and the bears are trying to take price down. After an enormous run-up from $100 to $442, these back-to-back monthly sell signals cannot be ignored. For two months these candlesticks show portfolio managers selling into this top and finally price comes crashing down because the buyers are few and now the sellers who see the top are many. The traders and hedge funds join in the selling by going short.

The blue arrows on weekly Exhibit 14.4 point to all the signs of supply that are taking price down. Starting at the top of the chart, RSI shows the movement from overbought, above the line in the green, down to oversold. It is now bouncing along the bottom testing the oversold line.

On the price chart, Exhibit 14.4, you have the Bollinger bands surrounding price and dramatically showing the change in direction from

EXHIBIT 14.5 CMG, November 7, 2012, Weekly
Source: StockCharts.com.

up to down. Notice that price breaks below the median line at the end of June 2012, and stays below in a bearish signal as price hugs the lower Bollinger band as it heads down. There is also a bearish violation of the lower band, indicating how strong the supply is, that will continue to take price down.

In addition, you have the lagging parabolic stop and reverse (SAR) dots confirming this change in character for CMG, just in case you are not thoroughly convinced that CMG has turned from bull to bear. Notice as price was moving up to a record high that the SAR dots were in a very long series underneath price, confirming that the trend is up. The series of dots above

price are very short, indicating short pullbacks during the long uptrend. These are signals to buy on weakness because price has not topped out yet.

Now, there is just the reverse and the long series of SAR dots are above price in a downtrend. The short series of dots under the price identify technical bounces with the message "sell into strength" because the trend is down. Thus, even with this latest bounce up caused by an analyst upgrade, the message remains the same because the trend is still down and there is no confirmed bottom in place yet. The parabolic SAR identifies when you should be buying on weakness on the way up looking for a top and selling into strength on the way down looking for a bottom. SAR reminds the hedge fund manager of this strategy.

HAMMER CANDLESTICK REVERSAL SIGNAL

However, this bounce up from the latest low of $234 has two, short-term bullish signals on Exhibit 14.4. There is the reversal signal, the hammer candlestick and a spike in volume on the weekly chart supporting the turn up in price and well before the analyst upgrade is announced. These positive signals have more reliability appearing on a weekly chart than when they appear on a daily chart. The hammer candlestick looks like a hammer head with a handle. The white body forms the hammer head and the long line or shadow down below the head forms the handle. This is an important price reversal signal especially when supported by a spike in volume. There are arrows pointing to the hammer and the spike in volume. The bears took price down but could not keep it down as indicated by the hammer candlestick.

This does not mean that a bottom is in place. Here, it simply means a strong bounce up to test resistance and the median line in the Bollinger band. Expect price to come back down and retest the bottom of the Bollinger band again at around $230. If you wait for price to come back down to $230 and you believe the latest analyst 12-month target of $320, there is an implied potential gain of 39 percent. This is very attractive and worth some fundamental research time and effort by a portfolio manager and his buy-side analysts.

Exhibit 14.4 signals below the candlestick prices seen at the bottom of the chart show supply. The MACD shows no sign of turning up yet. It will turn up as price attempts to put a bottom in place and that has not even started yet. The average directional movement index (ADX) directional plus D1 and minus D1 lines still show the red line above the green line and continued supply. However, the red line is dropping but notice last time it dropped for a possible crossover that it failed to correct the sell signal.

Will it do the same this time? The failure of the last test was a good signal to short the stock as demand failed to appear. Such signals are very important for hedge fund portfolio managers like David Einhorn confirming their fundamental decision that they should continue to remain short this stock.

COUNTING DOWN WITH FIBONACCI AND ELLIOTT

Weekly Exhibit 14.5 dated November 7, 2012, shows the Fibonacci retracement lines along with the normal 50 percent retracement line, which is not a Fibonacci line. The five count in Elliott waves to the downside are also shown. Both show that CMG is down for the "long count" pushing both indicators to their limits. Usually, retracements are 50 percent or less and the Elliott waves would be more like an a, b, c pullback or less than the five count down that appears on the chart.

This could be a long-term trend change to down rather than a bull stock retracement. We will soon know if CMG starts putting a bottom in place. The fundamental analyst at BAC-Merrill seems to think the bottom is in place based on his fundamental valuation. The hammer candlestick and spike in volume on Exhibit 14.4 are early markers reflecting the analyst upgrade. Technicians will wait to see the bottom form and then be confirmed (i.e., holding after another test). Most technicians will wait for a buy signal off the bottom. But fundamental bottom fishers will use fundamental valuation to buy. Is $230 the bargain price they want? The chart will tell us. As of November 7, 2012, on the weekly chart (Exhibit 14.5), there are no buy signals yet in price, volume, CMF, MFI, OBV, or most important relative strength (CMG: $SPY).

OPTIMIZE ENTRY LEVEL AFTER FUNDAMENTAL BUY SIGNAL

Exhibit 14.6 shows the monthly signals. On this long-term chart, the CMF is lagging and still showing a green signal but dropping sharply, which is bearish and close to turning negative. For those buy-and-hold portfolio managers still in CMG, this is the last positive signal that will still keep them in CMG.

Don't forget portfolio managers want a reliable signal that will keep them in stocks where the fundamental story is still intact even though they are looking at a 40 percent pullback off the high price. That is a great deal of performance pain for their portfolio. If CMG turns up from here as the BAC-Merrill analyst expects, then the CMF signal on the monthly chart will

EXHIBIT 14.6 CMG, November 7, 2012, Monthly
Source: StockCharts.com.

be the one that long-term portfolio managers will like. It will have stayed green through a very bad pullback and confirmed that buy and hold was the correct decision but a very painful one.

CMG is a stock looking for a bottom. The analyst upgrade may be the first fundamental signal that CMG is nearing a bottom. Fundamental analysis tends to be too early just as positive technical signals off the bottom tend to be late. This chart shows no sign of bottoming yet and therefore not even the first sign of a bottom in place. You can tell this analyst has made a fundamental decision and not a technical decision. His upgrade is way ahead of any demand showing up on the chart. It is typical for fundamentalists to be too early so there is no surprise that this analyst's call is early. Portfolio managers create trend demand, not analysts. Analysts create trading demand. Portfolio managers prefer early signals by fundamental analysts because it takes time to buy a large number of shares and avoid moving price up by their buying "in size."

WAITING FOR THE BOTTOM

The latest analyst's $320 target implies a low price of $246 if you are looking for at least a 30 percent gain in 12 months based on growth projections of 21 percent for 5-year growth and a current price-earnings ratio (PE) of 30. The analyst target implies you should not be buying at $281 but rather wait for lower prices, possibly a retest of $234. The analyst is not going to tell you this. You are supposed to figure this out from the target he has set and the current price.

If you go back to Exhibit 14.2, you will see that price almost made it to $282 on the analyst upgrade November 6, 2012. Then if you go to Exhibit 14.3, you will see price labels identifying various resistance levels such as $277.76, $283.60, $278.01, and $297.00. The 50-day moving average is at $296.72. Then in Exhibit 14.4, you will see the pivot point (P) at $299.58. There is enough resistance to stop this bounce up as indicated by the intersection of price resistance levels, pivot point, and moving average. Price will have a very difficult time reaching $300, and when it turns down, it will target a retest of $234 to see if the bottom is in place. You are looking for the "W" bottom where $300 is the middle peak and a "bull trap" to catch the buyers before price drops back down to retest the bottom.

Thus, a portfolio manager interested in this analyst's recommendation of a $320 target can use technical analysis to buy on weakness. Technical analysis will encourage him to wait for $234 instead of chasing price at $280 as it was going up after the announced analyst upgrade. There is no use chasing price as traders move price up based on an analyst upgrade, especially in

a downtrend stock such as CMG. Portfolio managers usually buy on weakness and will rarely chase price pushed up by traders and the latest good news. Traders know this and they will be ready to sell CMG short when it turns back down to test the bottom. Traders are not dumb and neither are portfolio managers, but they view buy and sell signals very differently.

On an overview basis, technical analysis would not suggest buying this at either $280 or $234. There are too many sell signals in place and no buy signals. But portfolio managers make their decisions based on fundamental valuation. If they think $280 is a great bargain, technical analysis and the technicians on the portfolio manager's own trading desk will tell him he may buy it cheaper than $280. Buying at $234 gives the portfolio manager a 22 percent gain next time it comes back up to $280 when the trend has turned back up.

There is no sign of this trend turning up on the chart. The portfolio manager might as well wait for the test of $234. Not only will the portfolio manager be in at a cheaper price, he will also know if $234 is the bottom. If it is not, you can see the next major support we have blue lined on Exhibit 14.6 is at $150. We don't want the portfolio manager buying at $234 if it fails on the test and goes to $150. Technical analysis wants the portfolio manager to wait for the downside test of $234 before following the recommendation of the BAC-Merrill analyst, who just upgraded CMG on November 6, 2012, with price jumping to $281 based on a 12-month analyst target of $320. All the signals on the monthly chart (Exhibit 14.6) are still pointed down: price, CMF, MACD, RSI, OBV, ADX plus D1 and minus D1, and, most important, relative strength (CMG: $SPY). The bottom of the Bollinger band is being tested.

SUMMARY

Every investor and portfolio manager must be able to recognize and act on signals that identify a top or bottom in a stock. Failure to do so will hurt portfolio performance significantly. In this chapter, we identified the technical analysis signals that will help fundamental investors identify tops and bottoms. Fundamental analysis will help investors identify when a stock is nearing a bottom or a top. Technical analysis signals alert investors to the formation of tops and bottoms. Both fundamental analysis and technical analysis combined provide the investor with a more timely identification of tops and bottoms. Using Chipotle Mexican Grill (CMG) as a case study, you see the technical buy and sell signals that identify tops and bottoms. Using these signals helps portfolio performance by moving investors out at near tops and in at near bottoms. It helps to avoid buying too early before the bottom is reached and selling too early before the top is reached.

Successful Stock Signals for Traders and Portfolio Managers: Integrating Technical Analysis with Fundamentals to Improve Performance, Thomas K. Lloyd, Sr.

CHAPTER 15

Using Money Flow, Trend Lines, RSI, Stochastic, MACD, and Buy/Sell Signals to Rotate In and Out of Losers, with J.P. Morgan and Goldman Sachs Exhibits

Why would anyone want to rotate in and out of losers? As Exhibit 15.1 for J.P. Morgan and Goldman Sachs shows, for the past 5 years, these stocks were losers. J.P. Morgan is a better loser than Goldman Sachs according to the chart. Portfolio managers must have a weighting in financials as required by diversification and risk management rules. They will overweight losers when they are bouncing up from the bottom. They will underweight losers when they start going down again. To help the portfolio manager and investor, we have to identify in this chapter the signals to buy the bounce and sell the top. The money flow index (MFI), Chaikin Money Flow (CMF), moving average convergence/divergence (MACD), stochastic, Keltner channels, and relative strength index (RSI) will all help the portfolio manager and investor to do this.

J.P. MORGAN AND GOLDMAN SACHS VERSUS THE REGULATORS

Banks were at the center of the financial panic that caused the 2008 stock market crash. We need to look at what technical analysis is currently telling us. Are these stocks showing the uptrends we look for in stocks? The world came very close to another Great Depression, saved by the Federal Reserve (Fed) because they learned from the mistakes in the 1929 Great Depression. However, the Fed is in uncharted waters and it remains to be seen if the "fix" by the Fed will work. The Fed alone cannot move us out of this Great Recession. Congress seems unable to act in the best interests of the country. This failure to act in concert with the Fed will show up in the market charts. Technical analysis will detect the next recession that is coming.

Regulations such as Dodd-Frank and the Volcker Rule will trim future growth and earnings of the banks, as will the tightened credit approval procedures. That will show up on the charts and in technical signals. Exhibit 15.1 shows what these two "best of breed" bank stocks have done during the last 5 years coming out of the crash. As you can see, these are not the stocks you wanted to be in for the past 5 years, except for a trade. Notice the red line for the 200-day moving average is down for J.P. Morgan. And Goldman did worse than J.P. Morgan, down about 60 percent compared to about 30 percent for Morgan.

EXHIBIT 15.1 JPM and GS, June 12, 2012, 5-Year
Source: Yahoo.com.

If the long-term trend line was not enough to keep you out of these stocks, just look at Exhibit 15.1 and see that performance never turned positive for the 5 years. Who would want to own the best of breed? Only those forced to be in financials for some diversification reason or for a trade. The big advantage the small investor has is that he is not forced to be in losers like these, because he can diversify without them. The small investor only needs 10 stocks in different industries to diversify and reduce risk.

If the small investor puts his money in an index fund, he will own these underperformers. The index funds use the small investor's money to buy these poorly performing stocks that are in the index. This inflates the stock price of losers with demand that is not driven by fundamentals. They distort stock prices and make it difficult to have an efficient market. They overamplify down markets and up markets. Index fund liquidation contributes to panic selling and market crashes creating irrational supply in excellent stocks. Every major market crash has led to regulation reform to prevent the same crash from happening again. This crash is no different and Dodd-Frank regulations prove it.

J.P. MORGAN BUY/SELL SIGNALS

Now you need to look at the more detailed technical signals to see what they are telling you about these two stocks. When they do turn up, you want to identify the signals that will help you catch the move and make sure you are not falling for a false signal. If you are a trader, for the short term, you want to identify the signals for the short-term trade. Let's look at J.P. Morgan first because the chart (Exhibit 15.2) is currently showing weakness as a result of big loss due to the high risk trades in the chief investment office operations in London, the so called "London Whale." The loss was over $5 billion and growing with talk of a possible $1 billion more.

As you already know, this is a chart that has to prove itself because its 5-year record is a loser. The chart shows that it is in a trading range, and you can trade it by buying the bottoms shown by our technical signals below and selling when the signals turn negative again. Exhibit 15.2 shows the trading range between $47 and $27. If a trader correctly picks the bottom and top, there is an implied 74 percent gain. Technical analysis helps the trader to do this. The fundamentals usually remain unchanged and are not very useful in this trading game. Sell-side analysts drive this trading, whereas the portfolio managers drive the investment game and long-term trends.

For the portfolio manager who is looking out 3 to 5 years, investing in J.P. Morgan was dead money for the 5 years on the chart. Pending regulations may continue to put the lid on price, keeping it in the current trading range. The technical signal you are looking for is a breakout above the top of the range on high volume. Until this happens, J.P. Morgan will remain an underperformer, hurting portfolio performance until it has a breakout

EXHIBIT 15.2 JPM, June 13, 2012, Weekly
Source: StockCharts.com.

that signals a change in trend. J.P. Morgan is good for traders and hedge funds. (Note that the price range we are talking about is the one visible in Exhibit 15.2, or you can draw a line connecting the tops and the lower bottoms to see it. You can also use Keltner channels to identify trading ranges. We will show this later in the chapter.)

SIGNALS FOR STOCKS IN A TRADING RANGE

Exhibit 15.2 is a weekly chart that shows the overview of the trading signals that will help catch the bottom and top of the trading range. In Exhibit 15.3, we will update this chart to show how price bounced up from the bottom to the top. Traders and portfolio managers will already know from Exhibits 15.1 and 15.2 that J.P. Morgan is in a trading range, and their tactics are to buy at the bottom and sell at the top. All the signals on the chart are designed to identify the tops and bottoms.

At the top of Exhibit 15.2, you can see that both the CMF and MFI give the topping out overbought signals for them to sell after hitting $46.19 in March 2012. Portfolio managers will not try to catch the exact top and will be selling into the MFI overbought green signal strength in February and March. It will take them time to unwind their position and they want to sell into strength. They will not wait for this extremely overbought signal above the MFI 80 line in the green to turn down and break below the 80 line, which is the sell signal, but small investors can wait for this.

Likewise, portfolio managers will sell into the peak of CMF, and you can see how high in the green this signal is, compared to the previous peak. The first sign of a CMF downturn in a trading range stock such as J.P. Morgan is a toppy sell signal. The continued drop in CMF from the peak down to the horizontal line is the sell signal for a trading range stock. You will not wait for it to turn red as you might with a growth stock. As soon as the top becomes apparent you sell. The strategy and tactics for using technical analysis signals is completely different for a trading range stock like J.P. Morgan, where you are quick to sell than for an uptrend growth stock like Apple or Google where you may accept 20 percent or even worse pullbacks.

During April 2012, all signals on Exhibit 15.2 have turned down. It is now obvious to everyone that price is going down to test the bottom of the trading range. Day traders, like sharks circling their victim in the water, love this type of predictable trade. Most successful traders are risk averse. Trading is very risky by its nature, so day traders are always looking for low-risk trades such as this one. Of course, they would prefer trades with absolutely no risk, but that occurs only when you have illegal inside information.

EXHIBIT 15.3 JPM, November 13, 2012, Weekly
Source: StockCharts.com.

The next best thing to illegal inside information is legal, insightful information for a trade with very low risk. That is what technical analysis is providing as J.P. Morgan heads down to test the bottom of the trading range once again. Successful traders usually have a bag full of tricks like this; otherwise, day trading becomes gambling. Professional day traders hate gambling. They prefer boring no-brainers that are very predictable and

make money day in and day out. Those day traders that gamble die broke. Successful professional traders have very good sources of information that tell them what to do, or a very good computer program that provides more winning trades than losing trades.

BUYING THE BOTTOM FOR A TRADE

Using Exhibit 15.2, you saw the signals topping out. You could make money on these sell signals by selling short, buying puts or selling covered calls against your portfolio holdings of J.P. Morgan. Notice as you come to the bottom at the end of May 2012, all the signals that were going down start to flatten out. Price seems to have bottomed at $30.83. CMF is still in the red but has turned up in a positive direction. Both OBV and accumulation/distribution have turned up, and relative strength (JPM: $SPX) also seems to be turning up.

Now if you turn to Exhibit 15.3, you will see if this was the bottom or not. Before you turn to the answer, you may want to make a decision as to whether you would buy as these signals begin to turn up. You could buy the stock, call options, or even sell put options.

TRADER'S BUY SIGNALS

In Exhibit 15.3, we have identified the trader's buy signals with blue arrows pointed up. If you decided to buy based on the signals shown on Exhibit 15.2, you were right, but it was an early and still a risky decision. The blue arrows show the weight of evidence for positive signals encouraging you to buy at somewhat higher prices to the early signals shown in Exhibit 15.2.

As expected, the earliest signals are to be found using the raw materials of all technical signals, price and volume. You can see that volume gives you an early positive signal even before price hits the bottom. This is followed by positive white candles off the bottom. One of these candles is the popular hammer reversal signal off the bottom, encouraging you to look for upward price movement. Then prices are stopped for a few weeks between $33 and $36, trying to break above the 50-day moving average in red. Finally, there is the big breakout week at the end of July. There is a big white candlestick going from $33 to $36.93, and it breaks above the 50-day moving average. The final stop is $43.54 as price tops out in October 2012. If you were cautious and waited for the breakout at $37, you still made 6 points on the trade or 16 percent in 11 weeks for a trade

that had the buy signals in place and confirmed. This is the low risk and high returns that professional traders and hedge funds prefer. Portfolio managers are happy earning 16 percent in 12 months, so 11 weeks is a dream come true, except they can't use a buy-and-hold strategy. Like the more acceptable sector rotation strategy, this is a stock rotation strategy where you buy stocks near the bottom of a trading range and sell them near the top.

Notice all the buy signal blue arrows in place before the buy at $37. In addition to the volume and candlestick buy signals identifying strong demand, OBV and accumulation/distribution have given definitive buy signals in June a month before price hits $37. These are the leading signals every technician is looking for and using for the weight of evidence decision to buy. The trader has complete confidence when price hits $37 on the breakout. There is no hesitation buying this breakout with all these buy signals in place. The lagging signals CMF and relative strength fall into place before the top is reached and are not as useful with stocks in a trading range. As Exhibit 15.3 shows, successful traders do not have to catch tops and bottoms to make a good living. They can use several positive signals confirming that it is time to buy with relatively low risk and well off the bottom.

Now let's look at the daily and monthly charts for J.P. Morgan to see if they add more color and evidence to the decision making process. Day traders would be using the daily chart as background to their 3- or 5-minute intraday charts. The portfolio manager would be using the monthly and weekly charts to make the buy decision and then the daily chart for short-term timing.

PORTFOLIO MANAGER'S BUY/SELL SIGNALS

The monthly chart (Exhibit 15.4) supplies the overview signals for the weekly chart we just looked at and analyzed. It will add some color and depth to the buy/sell signals on the weekly chart. We are switching from the trader's buy signals for short-term trading to the portfolio manager's buy signals. Once a portfolio manager makes a fundamental decision to buy and hold a stock for 3 to 5 years, only a dramatic change will reverse that decision.

Stocks may pull back to the 200-day moving average before bouncing up. Retracements of 50 percent off the high are not unusual. Apple's recent pullbacks in 2011 and 2012 are over 20 percent. Portfolio managers ride out these pullbacks if they are using a fundamental, buy and hold strategy.

Hedge fund managers and sector rotation managers will move in and out of these regular cycles.

Portfolio managers, holding stocks like Apple and Google for the long term, want a technical signal that will stay positive during a normal pullback to test the 200-day moving average. More important, they are interested in this signal giving them a reliable sell signal once that the long-term uptrend in Apple or Google is over. Likewise, and more important, with stocks going sideways in a trading range such as J.P. Morgan, portfolio managers want reliable technical signals to buy the bottom and sell the top of the trading range. They also want a signal to tell them the trading range is broken. That is why Exhibit 15.4 is so important to the portfolio manager.

Don't forget that the buy/hold portfolio manager is using a fundamental sell discipline. He wants to sell when a stock becomes extremely overvalued. He also wants to stay for the "last dance" and not sell too early; he wants to optimize his selling price. Technical analysis signals enable him to do that. If he doesn't use technical analysis, premature buying and premature selling hurt his portfolio performance. They will miss bottoms and tops by a wide margin. It is often recognized that purely fundamental buy/sell disciplines are usually too early. It is also nearly impossible to catch exact bottoms and tops.

Portfolio managers need to sharpen their trading skills to improve performance, and technical analysis is what all traders use. Portfolio managers either use technical analysis or they consult with their own trading desk to optimize buy and sell points for their stock picks. Portfolio managers are responsible for picking stocks. Their traders are responsible for optimizing the entry and exit level for these stock picks. Technical analysis is the communication device between the trading desk and the portfolio manager. Portfolio managers need to speak the language. If they don't, they hurt their portfolio performance.

In Exhibit 15.4, sell signals for the portfolio manager are identified as A, B, and C. Of course, A is the most important and the starting point. Once a stock starts underperforming the market on a trend basis as at point A on the chart, it is put on the portfolio manager's possible sell list. He cannot keep stocks that are underperforming as shown by JPM: $SPY unless he is a bottom fisher and these stocks are new, bottom-fishing buys. As you can see, even through the crash, J.P. Morgan relative performance trend was positive. J.P. Morgan was not doing worse than the market during the crash.

Point B is the downtrend in OBV confirming the underperforming trend seen in price compared to the market at point A. Going to the top of the chart to point C, you see CMF going into the red. This signal uses

EXHIBIT 15.4 JPM, November 12, 2012, Monthly
Source: StockCharts.com.

both volume and price to confirm the sell signal in Relative Strength performance at point A. As you can see, the monthly CMF signal stayed in the green all through the market crash confirming the relative strength performance shown on JPM: $SPY signal on the chart. You expect money flow to be positive for stocks outperforming the market. It is positive money flow that makes stocks outperformers.

The portfolio manager's sell signals would have kept him out of JPM in 2011 and 2012. However, as you can see on the chart in October 2012, CMF is now in the green and the question is will this positive money flow signal change the more important performance signal at point A? OBV has broken above the downtrend line. Will the relative strength break above the down trend line continue after November 12, 2012, the date of this chart? As of the date of this chart, the downtrend signal at point A is still in place. This most important signal for the portfolio manager is not yet encouraging a buy.

The portfolio manager must make a decision based on total return including dividends. So if J.P. Morgan improves from underperformer to just market performer, the 3 percent dividend will make it an outperformer on a total return basis, and that will be once again attractive to the portfolio manager.

When the portfolio manager received the sell signals late in 2010, he would have used the other signals in Exhibit 15.4 to sell into strength rather than selling into weakness. Thus, he would wait for the peak of the MACD and stochastic to sell into strength at $46. Not only would he sell into strength, but he would also have confirmation of the sell signal still being in place at the top of the next buy cycle. Sell signals are confirmed at the peak of a buying cycle, not at the bottom of a sell cycle. You need to see the sell signal staying in place when the buying is strongest to give you confirmation.

In the case of J.P. Morgan, you have confirmation of the sell signal at the peak of a buying cycle, enabling the portfolio manager to sell into strength thus optimizing his exit price. The sell signal is not the most important point on this chart. Confirmation and optimizing the sell price at the peak of the next buying cycle is the most important step in February 2011 at $46. Likewise, buy signals need to be confirmed at the peak of the next selling cycle when the sellers are really strong trying to break the buy signal. Thus, the green buy signal in CMF needs to survive on the next pullback in the MACD and stochastic. If it survives and relative strength turns up in trend, you will have a confirmed buy signal for the portfolio manager and he will be able to buy on weakness at the peak of a selling cycle.

GOLDMAN SACHS, BEST OF BREED

Almost everyone who has worked at Goldman Sachs (GS) raves about the firm and what a great workplace it is. It has the "best of breed" reputation on Wall Street. They tend to be the smartest guys or women in the room. Everyone wants to work for the firm and receive those high salaries and big bonuses.

Laws are always passed after every major stock market crash, indicating that the laws were behind the times and did not prevent the crash. You know the next stock market crash will be created by those operating well within the law. What they did to bring on the crash will be made illegal after the crash. Then those who live solely by the law will go looking for another loophole, another new financial product not yet regulated by the law to cause the next stock market crash.

The stock market is constantly making judgments about companies, their corporate cultures or business model and whether they are going to survive. Herbalife immediately comes to mind. Many companies have terrific fundamentals but the market has already put the *kiss of death* on them and this shows up in technical analysis and the charts.

You are repeatedly reminded that price is determined by supply and demand and not necessarily by fundamentals. Some companies are value traps; they have great fundamentals but their business model is failing. The fundamentals are beautiful, but are they going to survive in 5 years? In this book we have looked at Facebook, Hewlett-Packard, Herbalife, Netflix, Green Mountain Coffee, and Research In Motion. Which of these are going to survive, and will the charts and technical analysis alert you to the future Enrons? Yes, the charts will tell you!

GOLDMAN'S LATEST SELL SIGNAL

Exhibit 15.5 is the monthly chart of Goldman Sachs, and you will see we have identified the portfolio manager's sell signals where GS: $SPY counts first.

Goldman Sachs in Exhibit 15.5 shows a similar sell signal profile as J.P. Morgan, but notice that before this sell signal Goldman Sachs had another sell signal during the crash. Unlike J.P. Morgan, which did better than the market during the crash, Goldman Sachs did worse than the market, as shown at GS: $SPY at the bottom of the chart. The latest sell signal we identify with the blue line going up and down the chart in 2010 is still in effect in 2012.

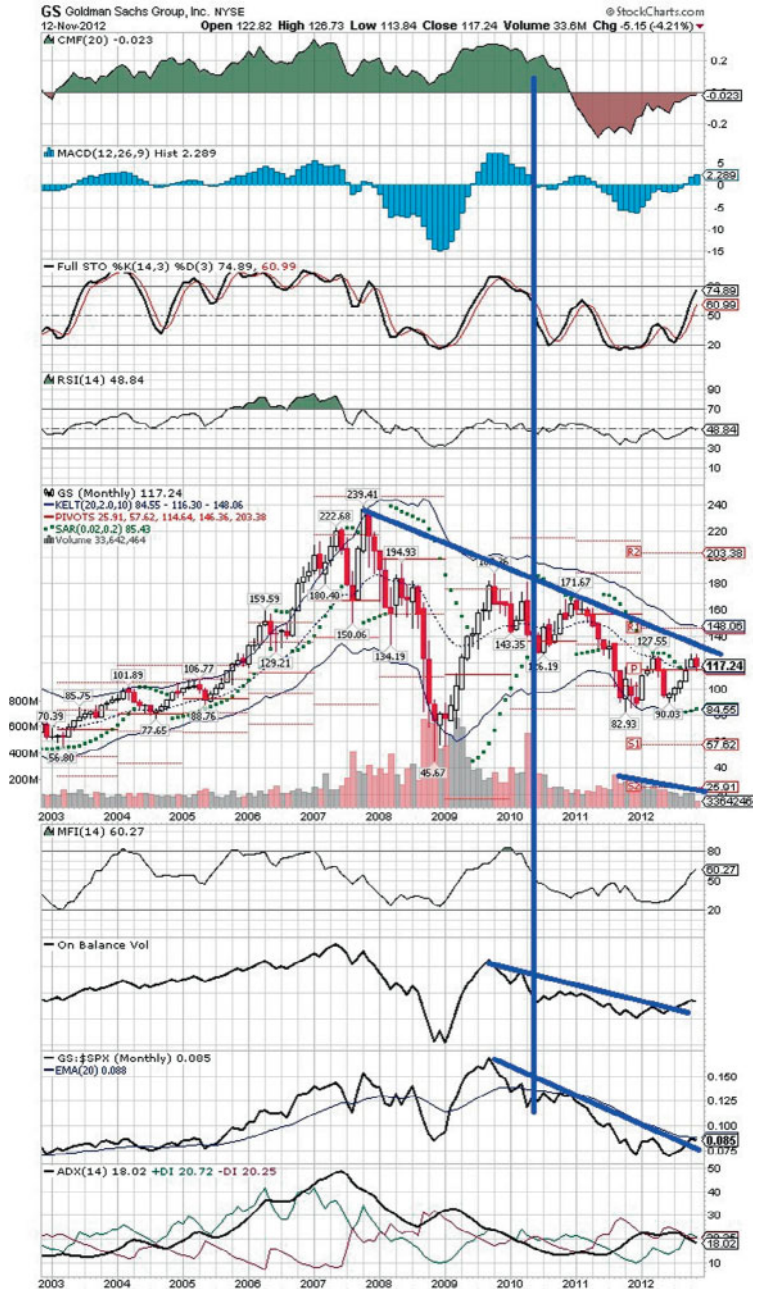

EXHIBIT 15.5 GS, November 12, 2012, Monthly
Source: StockCharts.com.

You can see the downtrend in price identified with the blue line connecting the lower highs in price as price is dropping. Price has yet to break above that negative trend line. Both OBV and relative strength (GS: $SPY) are in downtrends but making attempts to break above the downtrend lines in the fourth quarter of 2012.

Price is making attempts to the upside but on decreasing volume, which is shown with a downtrend blue line. There are no buy signals yet but at the top of the chart you can see that the CMF is trying to break into the green. The MACD and the stochastic are peaking in a buy cycle in an attempt to put a buy signal in place as price moves up to test the long-term blue line downtrend.

There is a double bottom in price and price is trying to break out. If no buy signal appears during this buying cycle attempt, it will confirm that the Goldman Sachs sell signal is still in place. The sell signal has kept buy/hold portfolio managers out of Goldman Sachs from 2010 to 2012 except for a trade. Bottom fishers may be buying the double bottom.

The Keltner channels around price are in a downtrend. Notice the light upper channel line runs down with our manually drawn bold blue line. The upper channel line price label is at $148.06 and the lower channel line price label is $84.55. But the most recent trading range based on price is between price labels shown on the chart at $90.03 and $127.55. The pivot point (P) has a price label of $117.24 and price is having difficulty putting in a buy signal by staying above P.

Price is also having difficulty reaching the downtrend line in blue which is about to intersect the pivot point line. There is still no buy signal in price supported by a spike up in volume.

Let's go to Nasdaq.com and check what the fundamental analysts are saying about Goldman Sachs on November 11, 2012. Only 7 of 21 fundamental analysts have buys. Goldman Sachs is at $114, and these analysts have a 12-month consensus target of $133. That is a 17 percent implied return for a stock that has a PE of 11 and a forward PE of only 9. There is a dividend of 1.75 percent to be added to the implied return. Some 13 analysts increased their earnings estimates recently. The Goldman Sachs forecasted growth rate is 21 percent and the PEG ratio is a bargain low of 0.43. Book value is $137. You get the picture. Goldman Sachs is a great value, or is it a value trap? Two thirds of the analysts refuse to give it a buy rating at this price level. The market apparently does not believe something about the quality of these fundamental metrics or something about the future of the company. The market will eventually sort it out and give you a buy signal or a continued sell signal.

One thing is certain and that is apparent from Exhibit 15.5—Goldman Sachs has not returned to business as usual before the crash. It has not returned to the solid uptrend in price. It has not even bottomed yet or

reversed the long-term downtrend in price shown by the blue trend line. For the time being, it has stopped putting lower lows in place. They are not able to print money the way they were doing before the crash. However, everyone is anticipating that the bond bubble will burst when interest rates begin to rise and shorting that bubble will coin money for some Wall Street firms.

IS THE GOLDMAN SACHS BOTTOM AT $86 OR $43?

The big question for the trader is where is the bottom to buy Goldman Sachs? For this answer we will switch to the daily chart for some insight. The monthly chart is giving no indication that Goldman Sachs will return to the crash bottom in place at $43. The monthly signals so far are giving some positive indications and $86 might hold. Certainly, the valuation at $86 might attract more buy recommendations from the fundamental analysts and $43 might attract even more. Exhibit 15.6, the daily chart, shows what the shorter-term signals are for the trader rather than the portfolio manager who is longer-term oriented.

As you can see at the top of Exhibit 15.6, the CMF has changed in character from green to red. The green positive money flow took price up from $100 to $126. Now the red negative money flow is taking price down. It is leading and coming before the other bearish signals on the chart. You can see it leads the downturn in the MACD, RSI, and full stochastic. As all these signals turn down, there is a bearish double-top formation, followed by a dramatic drop in price breaking through support. On November 7 and 8, 2012, price gaps down and drops from $126.73 to $115 on big volume. The drop in price is a culmination of the negative signals that came before it.

On the chart we show blue arrows pointed up where signals are turning up as price bounces up from support. The trader is interested in where this bounce will go. In view of the bearish signals pointed out on the chart, price at $117.24 will probably bounce up to retest the support level it broke at $122.60, which also happens to be the important pivot point. With this in mind, the trader would look at the day-by-day signals to make his trades and, if a day trader, the minute-by-minute signals. The trader must have this chart in front of him to remind him of the overview and which way to lean. He cannot afford to ignore the double top, the break in support and the big red candlesticks and volume spikes.

In summary, Exhibit 15.6 has blue arrows pointed up indicating a short-term bounce up from short-term oversold. This could be viewed as a mini dead cat bounce up that the day traders can play over the next week.

EXHIBIT 15.6 GS, November 12, 2012, Daily
Source: StockCharts.com.

SUMMARY

In this chapter, technical signals show you how to successfully invest in stocks that are trading in a sideways trading range or bottoming. Overbought and oversold signals are more important than trend following signals. Portfolio managers are not traders, but they will rotate in and out of sectors and stocks in a trading range because uptrend stocks are difficult to find in a sector that is out of favor. Hedge fund managers and traders are attracted to stocks trading in a wide range over time. Technical signals were applied to two case studies, J.P. Morgan and Goldman Sachs, both having losing 5-year track records. The importance of using monthly, weekly, and daily charts was illustrated.

Successful Stock Signals for Traders and Portfolio Managers: Integrating Technical Analysis with Fundamentals to Improve Performance, Thomas K. Lloyd, Sr.

CHAPTER 16

Day Trading Using Candlesticks, Real-Time Volume and Price, RSI, MFI, MACD, and 20- to 50-Minute Moving Averages, with Salesforce Exhibits

WHAT IS THE WORLD OF TRADING?

Traders follow only one rule to make money: identify and trade ahead of a coming wave of supply or demand, just like riding a surfboard. Legal front running involves using technical signals to do this; illegal front running uses inside information to do it. In this chapter, we focus on the world of day trading. Candlestick charts are the working tool of a day trader. They were invented by a Japanese rice trader and popularized by Steve Nison.

Candlesticks and volume tell you about the shifts in supply and demand, trade by trade, minute by minute on the real-time charting

supplied by most brokers or charting services. Traders will be looking for the doji reversal (it looks like a cross or a star) or the hammer and hanging man reversal signals on the candlestick chart. Day traders are most interested in reversals. It is the contrarian world of selling into strength and buying on weakness, using overbought and oversold oscillators. The stochastic, RSI, and MFI, based on 3- or 5-minute intervals, not 1-day intervals, help to identify the short-term support and resistance or tops and bottoms throughout the day. Breaking support or resistance levels throughout the day are key signals of demand and supply in action.

Accumulation/distribution, CMF, MACD, and OBV help them identify demand and supply with every big change in price, and as every significant large block buy and sell order creates the demand and supply. Large market orders throughout the day create an inefficient market, momentarily overbought or oversold. Day traders make their money when the big buyer or big seller is done and price returns to the mean. They sell short when price is overbought and go long when it is oversold much like the old specialists and market makers. They also play momentum created by a continuous stream of buy and/or sell orders taking price up or down continuously in one direction.

At any moment a high-frequency trading (HFT) robot computer can create havoc with demand and supply, blind siding and destroying any day trader with a flash crash. Every trader knows the *old saw* on Wall Street: "Traders die broke." Traders need to predict what the robots are going to do before they do it.

Traders need an edge such as seeing order flow before it hits the tape. They need to protect themselves from the unpredictable flash crash by risking only a very small amount of their total capital in any one trade. "Plungers," traders that bet the house on one trade, are the ones that die broke. The best kind of trading is low risk trading such as the pro that has 25 long and short positions open at the same time and is hedged against any flash crash. The small trader can do the same by having a related pair of stocks, one long and one short, to protect from the flash crash.

OBV and accumulation/distribution are useful. But the basics of support and resistance and candlestick chart reading are needed for the ultrafast moves of day trading. The patterns of support and resistance are key. Fibonacci levels may be calling the shots. Traders are always optimizing technical tools to give them an edge over those using classical technical signals or those used to program the HFT robot trader. If you come up with a better technical analysis signal, every trader on Wall Street must buy it from you to stay competitive (only if it is your trade secret and they can't figure it out).

TRADING TECHNOLOGY

Bloomberg started his company with just such a box and expensive cabling to feed the data to Wall Street trading desks. Now the Bloomberg is ubiquitous on the trading desks of Wall Street and beyond by using the Internet.

Technology does give an edge to professional traders that is not available to the small trader. Those with access to order flow information also have a leg up over everyone else. So the small trader is third in line on the food chain of information that leads to profitable trading. They can still make a great deal of money trading behind the pros, but not as much money as the pros.

Knowing the playing field, the small trader knows he will not catch the bottom or the top of a trade like the pros, but everything in between still makes the cash register ring for them. In fact, the small trader has an advantage because the pros must leave a signal on the tape that is easy to read with technical analysis signals. By trading after such signals, the small trader has less risk and, of course, less trading profits. Small traders are like the "pilot fish" swimming with the Wall Street trading sharks and feeding off the sharks. If the pilot fish tries to get in front of the shark, it will probably be eaten. When the small trader becomes greedy, he no longer enjoys the safety of the pilot fish swimming placidly next to the shark.

Shorting stock (or buying stock) ahead of anticipated orders by a customer, such as a portfolio manager, is called *front running* the order. One reason for examining front running is to determine the role of flash trading, black box computer trading, in detecting the drop in price during trading hours. Further, you want to know how that triggered the automated sell programs of the computers. These programs are using technical analysis triggers, detecting high-volume sales, as happened when someone raised questions about Herbalife on the company conference call and then automatically selling short the stock ahead of the anticipated sell orders from portfolio managers.

If the institutional broker has the portfolio manager's sell orders on his trading desk, it is illegal for him to front run the order or tip off another trader about the order. But if the computer programs were at some hedge fund, with no institutional trading desk, well then, it is making a decision based on the technicals, price and volume, and that is perfectly legal.

This may not last much longer because it leads to such a disorderly market, with enormous swings in price, the ultimate being a "flash crash." There is a need to provide human intervention to control the unbridled robot computer trading. The regulators are supposed to keep an orderly market and may decide to ban the computer programs or insist on human intervention to prevent flash crashes from happening.

This book looks at the egregious errors in market pricing. It is of interest to the unfortunate portfolio manager who has to sell his stock while there is panic in the market created by computer-generated selling. The black box programs show no mercy once they have identified a stock as a short. This is one of the problems in using black box technology.

Prior to these computer programs, portfolio managers might start reducing some of their position gradually. But now early fears detected by computer programs are instantaneously converted to sell orders. This results in a grossly inefficient markets with stocks greatly oversold based on fear rather than fundamentals. The overwhelming supply created by fear determines the price of a stock, not fundamentals. Traders see it happening and rush in to make a big profit.

HOW HAS TECHNICAL ANALYSIS CHANGED?

Years ago, technical analysis measured the gradual sell response of the portfolio managers. Now it measures the flash crash in a stock like Herbalife discussed in Chapter 4, which catches both fundamental and technical analysis completely by surprise. The technical analysis sell signal gave traders, hedge funds, and option players plenty of time to make money on the falling prices because price kept dropping for a few days. Many times, option prices lead the change in the underlying stock price. This is no surprise because options provide leverage and a person with the certitude of profitable knowledge or inside information can optimize his profits by using the leverage of options instead of the underlying stock.

Herbalife is just one case, of several that we have analyzed for the reader, presenting him with the challenge of the chart and then discussing what actually happened after the signals. Unlike Herbalife, most charts showed signals that can be acted upon to make quick profits by legally front running the trades that are yet to come from portfolio managers who are forced to slowly unwind their positions over time or sell them as a block below the market price.

When portfolio managers have large positions, such as in Apple, it takes a long time to rotate out of them. The portfolio manager has to start selling before the top, before the bad news comes out. Once technical analysis identifies the top and the trend in price changes from up, to flat, to down, the traders as well as the computers will be shorting the stock every time it bounces up to test the downtrend. Of course, the portfolio manager can always sell his whole position to the Wall Street institutional trading desks at below the current market price. They will take on the risk of selling for the chance at moving price higher for a quick profit. The salesmen

on the institutional trading desks know how to sell distressed stock in large blocks at higher prices.

TRADING PROFITABLY

The great benefit to the reader of the case study method is to experience real trading and investing cases, and learning from mistakes without losing any money. This book is the training necessary for making easy profits in the stock market. That is the objective. The by-products are learning technical analysis, the relationship to fundamental analysis and the trading desks with automated trading programs that move price around, many times causing prices to be inefficiently high or low.

As every professional trader and investor knows, easy money is made when markets are inefficient. Technical analysis identifies these opportunities and this book shows the reader how to turn those signals into quick and easy profits. After all, why should the Wall Street firms with their robot computer trading be the only ones to make the easy money, when the small guy with a brain, eyes, and a chart can act faster and more intelligently than their computer programs?

The human brain is much smarter and much quicker than any computer program. Humans can see it and hear it but computers have to wait for data feeds. While the computer programs are front running the portfolio managers, technicians will seek to identify the technical signals that will front run the computer programs. The small investor and trader have a very big advantage of speed over the big portfolio manager or trading desk. Just compare the individual's speed in selling short Herbalife to the struggling portfolio manager that has a $100 million to sell and you see the great agility benefit the small trader has. His market order will never move the market and will be executed instantly by his broker. The portfolio manager may be able to do the same thing except his order will move the market and take price down.

Although legal front running is very profitable, the more popular way of making easy money in the stock market is playing along with the professionals. Their game is to buy on weakness and sell into strength and thus help to maintain an orderly market. It is a contrarian style of trading followed by most professionals and greatly respected on Wall Street.

It takes courage and confidence to buy on weakness and sell into strength. The only traders who don't die broke are ones who have found a weakness in the market that they can exploit and ensure that their trades work. They have found a signal or a data feed that gives them an edge.

The small trader, using technical analysis moves in after them, selling on their signals and buying on their signals. Slower moving blue chips and

large caps are better for this copycat way of making money using technical analysis. Don't forget that the professional traders are always busy setting bull traps and bear traps for the novice trader. After all, the professionals need a buyer when they are selling into strength and they need a seller when they are buying on weakness. That is usually the novice trader.

Some readers will decide trading is not for them. Others will be happy to use technical analysis to improve their investment performance using "buy on weakness" and "sell into strength" technical signals. Every portfolio manager wants to learn how to use technical analysis to bail out of stocks like Enron long before they crash and burn. To do that, portfolio managers have to overcome their fundamental bias and use the trader's knowledge and use of technical analysis as part of their sell discipline.

CASE STUDY IN TRADING SALESFORCE.COM

It is Thursday, August 24, 2012, and Salesforce.com has just come out with a slightly disappointing earnings report. The stock trades lower in the after-hours Thursday and opens lower on Friday. However it bounces right up after the open on Friday and closes higher on the day. Traders and hedge fund managers like this stock because in just a few short weeks price jumped 28 percent. The challenge of this case study is to plan a strategy for day trading. You have to determine if there is a long-term double top in place encouraging you to sell into strength on this bounce up. Or will it recover its uptrend, and will price start putting higher highs in place?

See how Exhibit 16.1 looked after the earnings announcement. Notice how low the price opens on Friday (the latest price candlestick to the right on the chart) but then zooms up to close higher than the previous day's close. The bottom of the white body candlestick is the opening price $140.08 and the top of the white body is the closing price $148.54. This is a positive reversal signal, and price wants to test resistance at $150 to $152 after dropping down to test support on the open (see the drop on the Point & Figure chart [Exhibit 16.2] in red); price quickly bounces up from support to resistance in one day. This is the dramatic volatility that traders love because it produces very profitable day trades.

You can see on the daily chart (Exhibit 16.1) that the CMF is positive and in the green and rising just before earnings. But the percentage price oscillator (PPO) histogram is weakening, and it looks ready to start a selling cycle by dropping below the horizontal line. The powerful, long white candlestick reversal signal stands out as a powerful sign of demand, but is it enough to break above resistance at $150 to $152?

Now look at the Point & Figure chart (Exhibit 16.2), which emphasizes the reversal to the downside on the open of trading, but the reversal to the

EXHIBIT 16.1 CRM, August 24, 2012, Daily
Source: StockCharts.com.

upside has not yet triggered the row of X's to the upside to test resistance at $150 to $152. This is not as strong a picture as the candlestick's powerful upside signal. If price does test $150 to $152, you will see a new row of X's to the upside.

Here is my article titled "Is Salesforce.com a Buy on Weakness," published on MarketWatch.com after trading opened on Friday, August 24, 2012:

> *Does the mantra of buying uptrend stocks on weakness still apply to Salesforce.com? It would seem so because 27 of 31 analysts have it as a buy. Their mean 12-month target is 175, which implies about a 20% return even after some negatives in the latest earnings report. The stock traded down in the after-hours market Thursday, but bounced right back up on the open Friday. However, let's go to the chart which no longer considers CMR an uptrend stock.*
>
> *The weekly chart clearly shows when CRM was in an uptrend in relative strength vs. the S&P 500, identifying it as a consistent outperformer until 2011. Buying the pullbacks was a good strategy in such an uptrend. However, that uptrend is now broken. CRM flattened out to a market performer based on this indicator. Even worse, it started an underperforming trend twice, as the trend line in relative*

EXHIBIT 16.2 CRM, August 24, 2012, Point & Figure
Source: StockCharts.com.

strength was broken twice and turned down. (This Relative Strength line is clearly seen at the bottom of the weekly chart as CRM:$SPX.)

The latest negative downtrend in relative strength was reversing just before the earnings announcement. With the bad news on the company forecast, it remains to be seen if the positive change from underperformer to outperformer will occur. One thing is certain, there no longer is that strong uptrend encouraging buying any pullback.

While the portfolio manager is concerned about relative performance, the trader has no such interest. The trader and hedge fund manager are looking at the last pullback to $120 and then the big bounce up to $151 for a 26% gain in less than a month. Obviously, trading the pullbacks is still a very profitable strategy.

Unfortunately for the trader looking to repeat this move, the news was not bad enough to drive price down to $120 for a repeat bounce to the upside. Now if the trader looks at the point-and-figure chart, he sees an overextended move to the upside facing an evaluation of the bad news in the earnings report.

The quick bounce up on the open today was great for the day-traders, but will it hold in the face of what appears to be the end of a bounce up, not the beginning of a new bounce up? The point-and-figure chart clearly shows resistance at $150, and there was no news to trigger a move above that level. Traders are probably thinking a short-sale for price to go back and test support at $140–$142.

The models at StockpickerUSA.com are value oriented and don't like overvalued, aggressive growth stocks. The models do include technical models to tone down the value bias. Further, the system can adjust scores so that aggressive growth stocks are evaluated based on the growth universe of stocks, not the full 8,000-stock universe. On this basis, CMR has a favorable score of 11, composed of slightly better-than-average 4th decile for fundamentals, 4th for the forecast models and a good 3rd decile for technicals. (Adding up the decile scores give us the total score of 11 vs. the total worst score of 30 or best score of 3.)

Bottom line, if you are a portfolio manager, you are concerned about the lack of an uptrend in relative strength. Will CRM hurt portfolio performance going forward? If you are a trader, the last bounce up certainly proves the profitability of trading CRM, both short and long. Resistance at $150 will decide if it is a short-trade now.

Now you are ready to complete the case study challenge and map out your strategy and tactics as a trader going forward. How will you trade on Monday, August 27, 2012?

ANSWERS TO MONDAY'S DAY-TRADING EXAMPLE

For the traders, here is the daily Salesforce.com chart (Exhibit 16.3), the second day of trading after the earnings announcement. It is the chart for Monday, August 27, 2012. The first thing you will notice is that the day traders start buying right at the open. They are seeing that the buyers are coming in after the big, candlestick buy signal on Friday. Friday's buying stopped the selling.

Traders buying on the open at $148 have a nice gain as price runs up to $152, or just below it, and price is stopped at resistance. Tipping off the traders on the open was the price move above the 200- and 50-minute

moving averages that were already in uptrends. Also note the positive green dots under price, a positive parabolic signal that is a lagging indicator, thus really a late but safe signal that probably will not reverse quickly. As indicated in my article, the traders also knew that, at the very least, price was going to test resistance at $150 to $152 but probably fail on this first attempt to get above $152 signaling a breakout above long-term resistance.

Once the day traders have their position on the open, you can watch some other signals as guides, but the trader will be watching price and volume as well as the candlesticks and intraday support and resistance, because they will give an answer faster than any technical signal on the chart. Notice that we have signals on the price chart and below the price chart, but by definition they lag the basic input data of price and volume.

On the price chart (Exhibit 16.3) are signals that the trader is just using as background guide to what each minute-by-minute candlestick is telling the trader. Price is moving along the upper Bollinger band, which is great and a nice sign of continuing demand. The moment it ceases to follow that path and price turns sideways, you know demand is lessening. Dropping volume and sideways price movements also tell you this without the Bollinger band guide, but it stands out if the Bollinger band is on the chart. The trader is looking for a sell signal in the candlesticks. As volume drops and price flattens out, the trader is ready to pull the trigger and take profits especially after a 3-point move to the upside (because it is overbought and price is running ahead of itself). The trader also knows that price at some point will want to pull back and test the 50-minute uptrend.

As price reaches well-known resistance at $150 to $152, the trader is ready to sell. Price starts going sideways, breaking away from the upper Bollinger band. The candlesticks begin to waffle (instead of marching up nicely on a ladder) and show some signs of selling with the long tails (called shadows) to the upside, and small bodies indicating the attempts to the upside are not holding. If they were holding with good demand you would see nice white bodies instead of red bodies with long tails or lines (shadows) above the body.

We put in the parabolic signal, which is a lagging indicator, just to remind the trader that once he sees a lagging indicator in red, he has already overstayed his long position. Traders are using leading indicators, ones that move ahead of classical technical analysis indicators, in price and volume to take profits. When a lagging indicator turns red, it is an automatic sell. Notice that the parabolic briefly turns red for one dot. The signal is quickly reversed to green dots under price, but that one red dot is the signal to get out. It may be wrong but the trader can always buy back in. (Traders never hold a position because of transaction costs or even losses. They get out as soon as the position goes against them.) Once the green dots turn back to red again, you can see it is already too late and the trader has missed

EXHIBIT 16.3 CRM, August 27, 2012, 12:40 P.M., Intraday
Source: Yahoo.com.

selling at the top. But the candlesticks, volume, price, and Bollinger bands were already telling the trader to take profits. These could be false signals but the trader does not care. If the signals are wrong, he will just reverse his position.

Below the chart in Exhibit 16.3 are other concurrent signals that the trader is using to identify the top. The first one is volume, and notice that the green line tracking average volume turns down before the price top is reached. This is an early warning of weakness as price goes higher on lower volume. (We want price going higher on increasing volume.)

The next signal below volume is the MACD. It is identifying the top in price by flattening out and turning down. A concurrent to lagging indicator, like the parabolic SAR, tells the trader that he should be taking profits; SAR acts as a stop loss. So the lagging indicators are failsafe signals for the trader. He does not have to think about it. The trader should have sold before the SAR signal changed.

The next two signals below the chart, the stochastic and the RSI, also identify the top or overbought condition, but do not turn down decisively until price is off the $152 top and down below $151. This is good enough for the small trader but the pro wants to take profits at the top or as close to the top as possible. He is willing to sell early to accomplish this. He is following supply and demand on the tape using price and volume, and as soon as the buyers are gone, the trader is gone and will close his position.

The Point & Figure chart (Exhibit 16.2) shows that support to be $142. Exhibit 16.3 shows price has dropped at 12:40 P.M. to test support. The 50-minute moving average is at $150 and the Bollinger band is above $149, while the 200-minute moving average is at $148.

TIME FOR THE SECOND TRADE ON MONDAY—WHAT WILL YOU DO?

With Exhibit 16.3 on Salesforce.com, there is now another day-trading case study question. So far, as a trader, you would have bought on the open at 148 and sold at the top near 152. You may have decided to short at 151 because of weakness going into the lunch hour on Wall Street. Now you have to decide whether to play the bounce up or continue your short. There are signs of supply indicated by price dropping to the lower Bollinger band and testing the 50-minute uptrend. Also, volume has dropped dramatically, confirming that the buyers seem to be finished for the day. Just to be safe, should you wait for the stochastic, RSI, and MACD to turn up? Do you want to see green dots under price for the parabolic SAR, a lagging indicator that will cut your trading profits but reduce risk?

Hint: Most small day traders like to play the open, take their profits, and call it a day without doing a second trade. But, obviously, institutional traders have no such luxury and remain to trade for the rest of the day. They will buy on weakness when a big seller comes in and after the selling is finished; they will take profits when a big buyer comes in and takes price up. Likewise, when the buyer is finished, they will short the high price and cover when it drops back down to where it was before the buyer came in and took it up. All the little pilot fish proprietary traders will do the same. Even the robot computers know how to play this game with high frequency trading.

ANSWER TO THE SECOND TRADE ON MONDAY

As Exhibit 16.4 shows, the correct answer was to keep the short. The indications of weakness and supply were correct. Price broke the 50-minute moving average and even went down to test the 200-minute moving average. Not surprisingly, the 200-minute uptrend held and there was a bounce up. The short was good for 3 points from 151 to 148. It was a risky trade because you were trading against the uptrend but banking on price returning to the mean.

EXHIBIT 16.4 CRM, August 27, 2012, 2:47 P.M., Intraday
Source: Yahoo.com.

Now you can see price is bouncing up and that leads to another day-trading case study question. Do you do a third trade to the upside?

THIRD TRADE FOR MONDAY

Looking at Exhibit 16.4 you can see that the after lunch volume picked up and price bounced up nicely from the 200-minute support level. That uptrend is still intact and it looks as if price wants to go up and test the 50-minute moving average it just violated. Do you trade it to the upside? Or have you decided to wait for the bounce up to play out since you are already late to this trade and plan to short it at the top targeting a retest of the 200-minute? Take some time to come up with your answer, then look at what happened.

ANSWER TO MONDAY'S THIRD TRADE

As you can see from Exhibit 16.5, staying short or shorting the bounce up was the way to go. The bounce up looked like strong demand, strong enough to test the 50-day. But as it turned out it was just some big, lonely buy orders that were filled quickly. The pro probably went long at the bottom before the bounce, took profits as it failed, and probably went short again for the trip back down to test support. The pro would have easily spotted the demand drying up after the quick run up. The pro shorting is the bearish signal day traders pick up. Luckily, you don't need to be a pro to see the signal on the chart. It is there for anyone to see just looking at the price action and volume. If you need a crutch, you have the candlesticks and other lagging signals warning you about the lack of demand.

See if you can spot the negative signals below the chart. The MACD fails to break above the horizontal line (bearish). The stochastic fails to move back up to the last high mark above 80, the overbought marker on the scale (bearish). The RSI fails to move as high as the previous high (bearish). Volume fails to continue spiking up to move price higher (bearish).

On the price chart (Exhibit 16.5), the 50-minute trend turns down. The three strong white candlesticks that took price up around 2:30 P.M. are followed by three hanging-man candlesticks (a short dark head with a line stretching down, called the shadow or tail) which are bearish signals or supply signals. Finally, on the close, notice the two faint red dots above price indicating supply by the parabolic SAR signal, which is a lagging signal. Traders knew this bounce up after lunch would never make it to the

EXHIBIT 16.5 CRM, August 27, 2012, 4:00 P.M., Intraday
Source: Yahoo.com.

50-minute moving average, despite the good start. There were no more spikes in volume to take price higher. In fact, the next volume spike took price lower (a real sign of supply)!

This is a miserable end to a day that started off very strong. There is a "double whammy" here. Not only did resistance at $150 to $152 hold, confirming the strong resistance shown on the Point & Figure (Exhibit 16.2), but also you now have a negative (almost) shooting star candlestick profile on Exhibit 16.6 for the day (August 27). That happens when the upside move, indicated by the tail, fails and the resulting candlestick body

is small instead of big. This is a reversal signal because the test to the upside in price traced by the wick or shadow line failed in the attempt to close higher. Since the move was up after the earnings, this candlestick may be telling you that price, instead of continuing up above resistance at $152, will now go back down and test support again.

In the daily chart (Exhibit 16.6), you can see the shooting star candlestick, the last candlestick on the right. (*Note:* To be exact, the shooting star profile needs a smaller body and longer tail than you have in this instance.)

In Exhibit 16.6, not only is there a negative shooting star but also the PPO continues to flash a selling cycle as the histogram continues to drop. The CMF, however, is still in the green and rising, which is bullish. The market is still impressed with the big white body candle formed on Friday after earnings and on big volume. The signals reflect the battle going on between the buyers and sellers, the demand and the supply. Thus, you have to resort to the *weight of evidence* to come to a decision. This decision is negative because the negative signals override the positive CMF. The negatives are the failure of price to break above resistance at $152, the falling PPO histogram, and the shooting star candlestick reversal signal (the result of the failure to break above resistance).

EXHIBIT 16.6 CRM, August 27, 2012, Daily
Source: StockCharts.com.

TUESDAY'S DAY-TRADING CASE QUESTION FOR YOU TO ANSWER

Reviewing Exhibit 16.6 for Salesforce.com, you are challenged to prepare what your strategy and tactics will be for tomorrow, Tuesday's trading, August 28, 2012. Do you expect it to open strong as it did on Monday, or will it continue down to test support? Will your strategy be to play it long, short or both? If it opens strong what signals will you use to identify the top, so you can sell at close to the top? If it opens weak what support levels are you looking for? What signals will you use to identify a bottom? Will you get out before the bottom forms and price turns up? What lagging signal will you use to automatically sell, because when it flashes you know you have already stayed in the position too long?

ANSWER TO TUESDAY'S CASE STUDY CHALLENGE

Prior to the open of trading on Tuesday, I posted the following message on Twitter and Stocktwits referencing my article that was published on MarketWatch.com:

> stockpickerusa
> $CRM 149 http://t.co/yECFdaGX fails again at 152 resist, shooting star reversal? short?
> Aug. 28 at 7:45 A.M.
> **@tomlloyd12**
> $**CRM** 149 http://stks.co/e9PS fails again at 152 resist, shooting star reversal? short?
> 4:45 A.M. – 28 Aug 12 · Embed this Tweet

Using the *weight of evidence*, I gave a heads up on the short possibility. The Point & Figure chart showed resistance at $150 held because price just barely failed to hit $152 to trigger the next box up on the Point & Figure chart. The chart (Exhibit 16.7) shows the big drop in price on the open on Tuesday, August 28.

In Exhibit 16.7, you see all the negative signals at the close on the day before, indications of supply, which would take price down on the open. Price drops from the previous close of $149 down to $144. Also you can see clearly on this chart the 50-minute moving average breaking below the 200-minute on Monday and that sell signal carried into Tuesday. The enormous volume on the drop in price on Tuesday marks this as an intraday sell signal, and the bounce up is just an intraday dead

EXHIBIT 16.7 CRM, August 28, 2012, 10:53 A.M., 5-Day
Source: Yahoo.com.

cat bounce up from being deeply oversold, as indicated by the stochastic and the MACD signals below the chart. The day-trading plan would now be to short the top of the dead cat bounce looking for a retest of the bottom before the day is over. Until the sell signals are reversed, you are ready to short any bounce up. Use the MACD, stochastic, RSI, and candlesticks to identify tops.

Exhibit 16.8 is the Point & Figure chart that clearly shows the rows of X's failing to reach $152. To get past the $150 box, price has to hit $152. That did not happen on a couple of attempts and is one of the signals tipping the *weight of evidence* to negative encouraging a short sale at $150 to $151.9.

To close this discussion of day trading Salesforce.com, look at the last daily (Exhibit 16.9) for Tuesday, August 28. As you can see, there

EXHIBIT 16.8 CRM, August 28, 2012, Point & Figure
Source: StockCharts.com.

were two tops that you could have sold short. The first occurred around 11 A.M., and the stochastic and RSI signals identified the top. Also, price resistance was established earlier in the morning at $146.5. Another top appeared around 12:30 P.M. with a bearish gravestone candlestick. It looks like an upside down "T" and is a reversal signal like the shooting star. Unlike the shooting star, the candle has no body because the open and closing price were equal. But the long wick or shadow indicates the failure of price to hold when it moved up to the higher price at the top of the line or wick.

In the case of the first top, you can see the dramatic drop in volume creating a vacuum for price to fall. Likewise, there was a little shooting star

EXHIBIT 16.9 CRM, August 28, 2012, Intraday
Source: Yahoo.com.

candle to encourage your decision to short. Finally, notice that dropping price finds support at the 20-minute moving average. This is a key signal to close the short for a quick profit. Price needed to break below the 20-minute to be a continued short. Supply breaks supports, but demand holds support. In this case, the fact that price found support at the 20-minute for no reason whatsoever was an indication of demand.

Despite the support at the 20-minute line the overall picture is bearish because price never breaks above the 50-minute downtrend. As a result, there is no price attempt to move above the 50-minute and test the 200-minute line. This shows a real lack of demand and price goes sideway drifting lower toward the close even dropping below the 20-minute line. With price below the 20-, 50-, and 200-minute lines, there is a definite expression of supply on the close of trading for the day.

THERE IS MUCH MORE TO DAY TRADING

Our illustrations of day trading are simplified for easy reading and understanding. The experienced day trader is using many other advanced tools to obtain the advantage of speed in trading and information not generally available to the public, but available on advanced day-trading platforms. These platforms try to give you data very close to that of the pro. Many of these advanced trading platforms are available from brokers specializing in day trading. Level II trading platforms are generally available from any broker but the professionals use even better platforms.

These advanced tools are necessary for those doing hundreds of trades a day for very small profits, pennies per share. This is high-frequency trading done by people instead of robots. Our purpose here is to illustrate the use of technical analysis in day trading, not to teach you how to become a day trader. That would take a book, just as candlestick charting would take a whole book to explain properly. These books are already widely available in the marketplace.

SUMMARY

In this chapter, you used the tools of the day trader: the daily, intraday chart in 5-minute intervals; price measured by minute-to-minute candlesticks on the trader's screen; volume; the overbought and oversold oscillators RSI, MFI, and stochastic; the MACD, the Point & Figure chart for support and resistance targets; 20-, 50-, and 200-minute moving averages; intraday support and resistance price levels; and the lagging indicator parabolic SAR.

In the case study section using Salesforce.com as a day trading example, we challenged the reader to make three trades on one day and preparation of the trading strategy for the next day. The case study set up the trading challenge and then gave you the actual answer as it happened during the trading day.

Successful Stock Signals for Traders and Portfolio Managers: Integrating Technical Analysis with Fundamentals to Improve Performance, Thomas K. Lloyd, Sr.

CHAPTER 17

Investors Need Reliable Signals

50- and 200-Day Moving Averages, Money Flow, Relative Strength, and Directional Movement, with Apple, Home Depot, and Wal-Mart Exhibits

Investors need reliable buy and sell signals that will keep them in a stock for the long-term, in stocks like Apple. Identifying long-term bottoms and tops are key. Relative strength versus the index is the most important. Price patterns such as the double bottom and double top are well known. Candlestick reversal patterns such as the hammer at the bottom and the hanging man at the top are familiar to traders.

Look for negative divergences when the money flow index (MFI) or on-balance volume (OBV) fail to confirm price moves you are seeing on the charts. Gaps, trend lines, and the 50- and 200-day moving averages are all pieces of the puzzle for buying stocks at the bottom and selling at the top. The head-and-shoulders top as well as the inverted head-and-shoulders bottom are classic patterns well known by every investor and portfolio manager. Technicians use pivot point to identify support and resistance levels automatically and Fibonacci levels to calculate retracement levels.

Major support and resistance levels provide one of the key technical signals when they are crossed in either direction. The Point & Figure chart provides one of the most reliable sources of support, resistance and reversal signals. The 50- and 200-day moving averages also guide support and resistance levels, as well as establishing trends. As important support levels are broken, the top is confirmed. Likewise, as important resistance levels are broken, as price moves up, the bottom is confirmed to be in place.

Weekly stochastic, relative strength index (RSI), and moving average convergence/divergence (MACD) signals help portfolio managers to buy

on weakness and sell into strength when they are rotating in and out of long-term positions. Position traders or swing traders also use these overbought and oversold signals. Trading signals will be covered in Chapter 18.

FINDING GREAT STOCKS SUCH AS APPLE

Most of what you see on TV and read on the Internet or in magazines and newspapers is for the investing public. Traders are interested in breaking news and surprises. Portfolio managers are interested in buying stocks for the long term, using a buy-and-hold strategy. Most small investors have seen the enormous returns on individual stocks like Google and Apple. They are looking for the new stocks that will give these tremendous returns, far better than putting money into an index fund that has resulted in almost zero return for the past 10 years.

I once met a retired fireman. He looked too young to be retired. I asked him why he no longer had to work. He told me that years ago he invested in a little-known company called Berkshire Hathaway. There are many stories like this. The latest billionaire is Mark Zuckerberg, and there will be many other millionaires among the employees of Facebook. Whether Facebook is another Google is the big question. There are no technical buy signals yet, but it is still early. Our discussion in this book of Google, Apple, and IBM shows you the signals to look for in a long-term winner. Facebook and LinkedIn have to prove themselves.

The challenges for both the small investor and the professional portfolio manager are to find the great investments for the future. Since you are lucky if one of these come along in any given year, investors have to turn to the existing companies and find the ones that are on a 50-year run, outperforming the index by a good margin.

Of all the stocks that have good fundamentals, easily identified by the analysts of Value Line or Standard & Poors (S&P), what are the technical signals you can use to keep you in the winners and away from the "value trap" losers? In our case studies, we have identified our favorite signals, but some of these are not suited for long-term investing. The technical signals for the portfolio manager must be extremely reliable.

The last thing a portfolio manager or any investor needs is a buy signal that quickly reverses itself. All investors start with fundamental analysis. Portfolio managers pay for and receive the best fundamental information from the best analysts. Small investors don't need such high-powered research because they can move in and out of a stock with ease if their research is wrong.

The portfolio manager has no such luxury. He needs not only good fundamentals but a technical analysis overlay that will give very reliable signals. He is willing to sacrifice the earliest technical signal for the most reliable technical

signal. These are the ones that change slowly and are right most of the time. Don't forget, a portfolio manager is making his final decision based on fundamentals and other factors. Technical analysis and its signals are just more data points for him or her to consider in the final decision to buy or sell a stock.

So for the portfolio manager and small investor, we are going to look at the most reliable technical signals and sacrifice timeliness for reliability. Enron dropped from over $90 to $70 before I had a reliable technical sell signal for the portfolio managers. But there were portfolio managers, trusting fraudulent fundamentals, who refused to sell Enron until it was too late. A technical analysis overlay on fundamentals gives an edge in the buying discipline and sell discipline of any investor or portfolio manager. It is much easier to be a winning portfolio manager by first having a fundamental buy and sell discipline, and then overlay those decisions (not replace the fundamentals) with technical buy and sell signals.

The first technical signal you are going to look at is relative strength, the price movement of the stock relative to some index like the S&P 500 Index. The second signal is the 200-day moving average. Let's look at some stock charts showing these two important signals for long-term investors who have already done their fundamental due diligence.

Apple is the first. Most analysts and portfolio managers would classify Apple as a stock with excellent fundamentals and growth at a reasonable price. The unknown future without Steve Jobs and increasing competition are concerns. The 12-month analyst targets range from the consensus mean of $775 to over $900 for the highest estimates. Apple is trading for $572 on November 26, 2012. Using the $775 target for Apple implies a 1-year return of 36 percent. There aren't too many excellent fundamental stocks with this type of potential appreciation.

This stock is not any new discovery or flawed with serious fundamental issues such as the Facebook IPO. Notice the beautiful uptrend in the 200-day moving average in Exhibit 17.1. Even the current selling has not yet tested the 200-day. Further, and more important, look at the uptrend in relative strength price performance of Apple compared to the S&P 500 Index. These technical signals are saying "buy on weakness."

If you followed this message and bought the November 2011 test of the 200-day at $363, and sold at the April 2012 high of $644, you made 77 percent in six months. As you can see, the crossover signals on the percentage price oscillator (PPO) at the top of Exhibit 17.1 would have you trading close to the bottom and top. Of course, long-term investors don't do this, and it is next to impossible to pick tops and bottoms to achieve the 77 percent optimal trade. In addition to PPO, relative strength (AAPL: $SPY) broke to the upside in January 2012, confirming the PPO buy signal flashed in December 2011.

Let's look at some other stocks for this great combination of fundamental and technical signals.

EXHIBIT 17.1 AAPL, June 13, 2012, Weekly
Source: StockCharts.com.

DOW 30 STOCKS

For illustration purposes, we will use the Dow Jones Industrial Average (DJIA) 30 stocks to select a few good stocks. This has the advantage of picking stocks from a well-known index, instead of buying the whole index to replicate the index returns. We have already discussed a couple of these stocks. These stocks are already prescreened and fundamentally sound blue-chip stocks. The stocks are widely followed by portfolio managers and analysts. They are very liquid and not easily manipulated by options players or hedge funds. Like thoroughbreds, their pricing action usually runs true to form and pricing tends to be efficient. There are positive and negative earnings surprises that will invite trading. There are enough uptrend, downtrend, and trading range stocks to make the list interesting from a technical analysis point of view.

Because portfolio managers pay for the best research, you cannot duplicate the "special situation" research they may have in making their fundamental selections. You could go to the library or go online and, for free, use the Value Line service to rate the 30 Dow stocks. In addition, Value Line would supply a one-page fundamental analyst write-up on each stock giving all the fundamental data you would ever want to look at (or not look at) as a technician.

Because this is a book on technical analysis and not fundamental analysis, we will take some short cuts. Instead of Value Line ratings, we will use our own program to rate the 30 stocks. It is a system I have used for over 20 years. It looks at fundamental and forecasted data, as well as technical data, and equally weights all three. It decile ranks the stocks in a universe of over 8,000 stocks. First decile stocks are in the top 10 percent. The best score of 3 means the stock is first decile in fundamentals, forecast and technicals. Thus 1 + 1 + 1 equals 3, and the stock is first decile, top 10 percent, in all three categories. The worst possible score for any stock is 10 + 10 + 10 or 30. The system also rates the stock a buy hold or sell. We will look at all the charts rated buy by this program and pick the best charts (not the best fundamentals). We could do the same for the S&P 500 stocks, which is what we do in the next chapter.

Just like the portfolio managers and investors, our first step is going to be a fundamental step with the caveat that portfolio managers will have much better fundamental analysis than what we are using. Our next step will be to overlay the technical on the fundamentals using charts and all the signals we have discussed in this book, if they apply to the chart. We may use some new signals if they are appropriate to our analysis of the stock.

The stock picking system identified the following buys on November 18, 2012: Home Depot (HD) $62, United Health (UNH) $52, Chevron (CVX) $102, Procter & Gamble (PG) $67, Merck (MRK) $43, IBM $187, United Technologies (UTX) $75, Travelers (TRV) $69, Exxon (XOM) $86, Coca Cola (KO) $37, J.P. Morgan (JPM) $40, Bank of America (BAC) $9, Cisco (CSCO) $18, Johnson & Johnson (JNJ) $69, ATT (T) $33, Wal-Mart (WMT) $68, Verizon (VZ) $41, and Boeing (BA) $71. So 18 out of the 30 Dow stocks made the first cut based on this screening system.

A quick glance at the charts and the long-term technical signals trimmed the list. Now we are going to look at the charts to see the best performing of the fundamentally good stocks. Many technicians would not even bother screening for fundamentals but here we are illustrating the technical overlay approach for portfolio managers and investors who make their selections based on fundamentals.

The next step is to sacrifice a bias for the best fundamentals in exchange for a bias for the best performers; technical analysis is designed to do just that. Fundamental analysis identifies the stocks that should have the best performance. Technical analysis identifies the stocks that actually show the best performance. It takes a list of fundamentally acceptable stocks and only selects the outperforming stocks that have solid uptrends in performance relative to the S&P 500. Technical analysis selects stocks with a bias for performance. That is how it helps portfolio managers to improve the performance of the stocks they selected with a fundamental bias. The small investor can also use this methodology, especially if he has a fundamental bias.

HOME DEPOT—ANATOMY OF A BUY

One of the stocks, selected by the stock picking system I use, was Home Depot. As you can see in Exhibit 17.2, it has beautiful technical signals. These signals are still in place as of November 21, 2012. It is outperforming the market showing a nice uptrend in relative performance shown on the chart as HD: $SPX. The chart identifies all the beginning buy signals with a blue up arrow. Technical analysis enables you to identify these stocks at the beginning of the move up. Notice the sequence of the

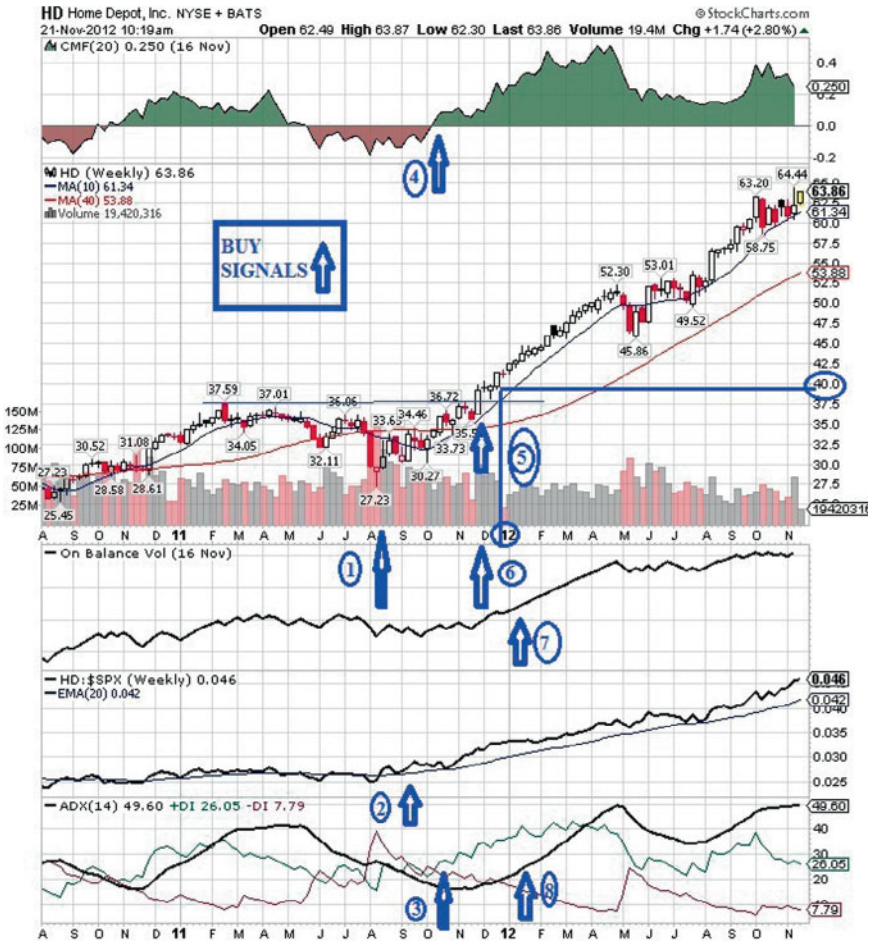

EXHIBIT 17.2 HD, November 21, 2012, Weekly
Source: StockCharts.com.

numbered, blue arrow buy signals where the #5 blue arrow is the decisive buy point.

1. In August 2011, are the first early signals of bottom fishing that starts this tremendous move up. Notice the perfect red hammer candlestick, a reversal signal, after price hit a low of $27.23. In the next 2 weeks, white candlesticks identify price moving up to $33.65 on excellent volume. It takes 7 more weeks for price to break above the 40-week (200-day) moving average (red line) and price never retests the low at $27.23. This failure to retest was a very bullish signal of strong demand taking price up.
2. In September 2011, Home Depot puts in place the most important buy signal on the chart, relative strength, as price tests the 200-day at $35. You can see that HD: $SPX signal has turned positive, breaking above the moving average line, and tilting the direction of the moving average line up. Home Depot is now outperforming the S&P 500 Index on a trend basis, upgrading its status to outperformer. It is showing demand better than the market. Portfolio managers want stocks that are outperforming the market. This change in signal will attract more demand and higher prices.
3. Another important buy signal is when the plus D1 green line moves up with a positive crossover above the minus D1 line in red and moving down. This happens in October 2011 as price breaks above the 200-day at $35. There are three very important signals now in place: relative strength, the 200-day, and plus D1. Portfolio managers are buying based on fundamentals and these signals confirm that they are buying. This is very important demand showing on the chart.
4. In October, another buy signal appears at the top of the chart as Chaikin Money Flow (CMF) turns green. This confirms that money is flowing into this stock and the early buy signals of relative strength, the 200-day, and plus D1 will stay in place. You are looking for reliable signals, and the convergence of these buy signals gives you that reliability needed for a long-term buy.
5. Now you have reached the decisive point where the weight of evidence is so compelling in terms of all the buy signals in place, that a technician, without knowing anything about fundamentals will confidently buy Home Depot. At arrow #5 the *death cross* sell signal is eliminated as the 50-day moving average moves back above the 200-day for a *golden cross*. Price also breaks out above the blue resistance line we have drawn from the last high at $37.59 in February 2011. Volume confirms the breakout in November 2011 at $39. In December, the breakout is tested and price stays above $37.59. At the end of December,

Home Depot is a technical buy at $40, based on multiple buying signals and the overwhelming weight of technical evidence that Home Depot is a buy.

6. In the #5 blue arrow, price signals confirm that Home Depot is a buy. In the #6 blue arrow volume spikes support these final buying signals. Thus, both volume and price are providing the reliable signals needed for a long-term decision to buy this stock and put it in the portfolio.
7. In January 2012, on-balance volume (OBV) gives a decisive and lagging signal confirming what you have already seen in volume in #6.
8. Likewise, the average directional movement index (ADX) line, the dark black line mixed in with plus D1 and minus D1, starts an uptrend in January 2012, confirming this is going to be an important move in price. Thus, you should not be surprised when Home Depot reaches $64.44 on this chart. If you bought at $40 when the weight of evidence was confirming all the buy signals in place, you realized 63 percent in less than a year.

Obviously, after such a tremendous move up, it is time to be looking for any sell signals. Long-term investors are looking for tests of the 200-day uptrend and will not sell until price is extremely overvalued. Buy-and-hold investors expect long-term uptrends to hold. They will reduce their holdings in Home Depot as price goes up, not because the fundamentals are changing, but because of risk and the fact that too much of their portfolio is in Home Depot. This type of portfolio selling may take Home Depot back down to test the 50- or 200-day moving average.

If our major buy signals begin to reverse themselves, it will warn the portfolio manager that something is wrong. It is time to reexamine the fundamentals to find out what the sellers know that he might not know. As the weight of evidence in sell signals mount using technical analysis, the burden of proof is on the fundamental portfolio manager, because market participants who are just as smart in the fundamentals are selling. These sellers could include hedge funds and famous short sellers.

On November 23, 2012, a quick check of Nasdaq.com showed that only 11 of 23 analysts had buys for Home Depot, and the consensus target was only $69, while price had already reached $64. According to Yahoo.com, an analyst downgraded HD to “market perform,” but that was before the recent earnings announcement. Finviz.com showed that the same analyst raised the target from $61 to $67. In addition, Finviz.com showed two analysts with buy ratings raising targets to $67 and $69, respectively, after earnings came out. This would seem to indicate that Home Depot is no longer the bargain it was at the beginning of the year.

With buys being reiterated by analysts, and targets being raised, you can see the dilemma the portfolio manager faces. Even though he is long-term buy and hold, he may have to trim his position back because the value has gone up 60 percent, and his position in Home Depot is now too large. He wants to sell into strength before the overbought oscillators in Exhibit 17.3 turn down. He will be selling not because the fundamentals are bad but because he has too much of Home Depot in his portfolio and the price of the stock is "ahead of itself" or overvalued on fundamentals.

EXHIBIT 17.3 HD, November 23, 2012, Monthly
Source: StockCharts.com.

As you can see on the monthly chart (Exhibit 17.3), RSI is in the green, overbought, for this whole move up since the beginning of the year. This shows you, it can stay overbought for months. When this move up is over, it will break to the downside. Likewise, the stochastic signal at the bottom of the chart is overbought since the beginning of the year. It, too, will break to the downside when this move up in Home Depot is over.

The most interesting signal is MFI. You can see on this 10-year chart that it has never been in the green until now. This overbought signal is definitely encouraging the portfolio manager to sell into strength if he needs to trim his Home Depot position. The MACD signal is still peaking (i.e., the bars are still moving up). This means the portfolio manager does not need to rush his selling. Notice the negative divergence in volume as price moves higher while volume is dropping, which is a sign of underlying weakness.

There was an attempt to stop this move up in the second quarter of 2012. You can see the red candlestick and the red spike in volume. This selling failed to stop the move up and failed to trigger sell signals in RSI, MACD, MFI, and stochastic. Traders and hedge fund managers will wait for these sell signals before selling Home Depot short.

TECHNICAL ANALYSIS WITH FUNDAMENTALS

Standard & Poors provides a chart that combines both technical and fundamentals for Home Depot and is shown as Exhibit 17.4. Point A circled on the chart shows two up arrows indicating good earnings reports. The line going up in steps is the 12-month analyst target price for Home Depot, and you can see the target was upgraded twice in this circle. In circle A, the chart also shows two technical buy signals as price breaks above the 10-week (50-day) moving average and above the 30-week (150-day) moving average. This was the start of the move up from $40 to $64. Also, at point B, we circle the third technical signal on this chart as relative strength breaks out, showing Home Depot changing from a market performer (sideways line) to an outperformer (uptrend line).

This chart shows the bare bones of fundamentals and technicals for Home Depot. It gives the fundamentalist a combined picture of what is happening fundamentally and technically. It reflects the way most portfolio managers and investors use a minimum of technical analysis signals. The chart shows very graphically that price is "running ahead of itself" by being well above the 12-month target of this analyst. Therefore, based on this analyst target, the stock is currently overvalued. Technicians would say that the demand taking price up is looking at a higher target than the one on this chart, which is around $50. The target on this chart is well below the consensus target of all analysts at $69.

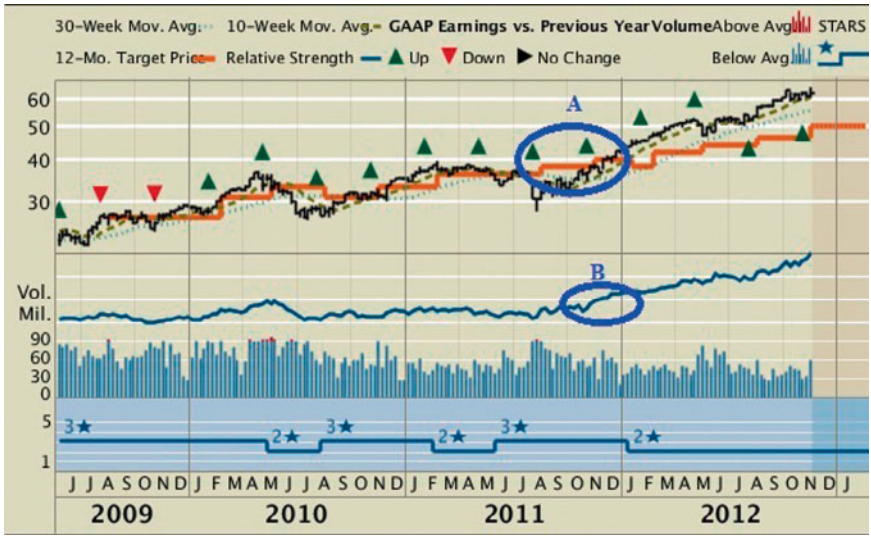

EXHIBIT 17.4 HD, November 2012, Weekly
Source: Standard & Poors.

WAL-MART—ANATOMY OF A BUY ON WEAKNESS

Wal-Mart was another stock selected from the Dow 30 (DJIA) as a buy with good fundamentals. As you can see from Exhibit 17.5, the chart signals are in agreement. Much like Home Depot, all the buy signals were in place before the beginning of 2012. Price then broke out at $55 and moved up to a high of $78 in October 2012, for a 42 percent move in less than a year. The buy signals are identified with blue arrows pointed up.

Unlike Home Depot, Wal-Mart has already started a pullback from its recent high and is testing the 200-day moving average. Price broke below the 50-day in October 2012. RSI and relative strength also broke down at the same time. RSI was overbought since June and was in the green. In November plus D1 and minus D1 had a negative crossover sell signal. PPO gave an early warning in September when it turned down along with the PPO histogram. CMF also started dropping in September, reaching the horizontal line in November, but still has not broken below into the red.

The latest week, on this November 23, 2012, chart shows a positive white candlestick as price bounces up from its first test of the 200-day moving average. This bounce up is flashing "buy on weakness." You probably will wait for confirmation by waiting for other signals to turn up. RSI has

EXHIBIT 17.5 WMT, November 23, 2012, Weekly
Source: StockCharts.com.

turned up. You are waiting for PPO and RS to turn up. Then, you expect to see the positive crossover with plus D1 moving above minus D1, and CMF must start a bounce up again indicating the positive money flow is back. So far, this looks just like a normal pullback from overbought to test the 200-day sharp uptrend. Such pullbacks are "buy on weakness" opportunities.

Professionals are always ready to buy on weakness when stocks with good fundamentals pull back in price because of market conditions.

Let's double check my system's selection of Wal-Mart by going to Nasdaq.com. Here, 11 of 21 analysts have it as a buy, and the consensus 12-month target is $80. As you can see on the chart, as price approached that target, it quickly pulled back. Recent analyst earnings estimates show 9 out of 12 were up. This would indicate price is merely pulling back from being overbought. In other words, price was getting ahead of itself. Thus, even on a fundamental basis, it would seem this is a usual "pullback to the mean." Technicians would be looking for demand and supply to give them the answer on the chart. They are only casually interested in what is creating the demand and supply. They don't want the story to prejudice what they are actually seeing on the chart.

Likewise, let's check the Standard & Poors chart for Wal-Mart, which uses both technicals and fundamentals to see what their view is as we did with Home Depot.

As you can see in Exhibit 17.6, we have circled the buy signals in the fourth quarter of 2011. The upper circle shows an up arrow for good reported earnings. The analyst increases the target from near $60 to near $70. You can clearly see price moving above both the 10- and 30-week moving averages. In the lower circle, relative strength turns up and Wal-Mart starts outperforming the S&P 500 Index. This starts the move up in price from $55

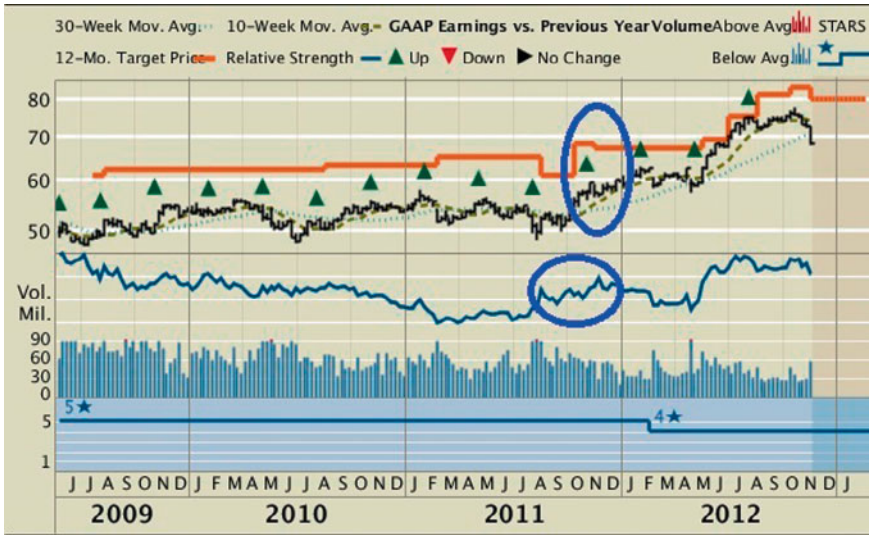

EXHIBIT 17.6 WMT, November, 2012, Weekly
Source: Standard & Poors.

to $77 at the top of the chart. Note that the analyst's target is above price for most of the chart. The dramatic increase in the target in the fourth quarter of 2011 correctly identifies the beginning of a dramatic move up in price. In November 2012, the target drops slightly as price drops. This is the first drop in target since the beginning of 2012 and the target stands at $80, the same target as the consensus of most analysts.

Technicians are not interested in these fundamentals. Here, we are illustrating the overlay of technical data on fundamental data. The Standard & Poors chart illustrates this overlay in a simplified manner. Portfolio managers have enormous amounts of fundamental data at their fingertips. They make their decisions based on this fundamental data. But they also need enormous amounts of technical data in the decision matrix in order to emphasize performance over fundamentals. Portfolio managers are paid for performance, not just for going with good fundamentals. A fundamental bias hurts their performance because they will pick the best fundamentals. Charts show that the best performers frequently do not have the best fundamentals, but rather good fundamentals. That is because fundamentals are only one factor in creating demand for a stock and many times not the most important.

SUMMARY

This chapter looked at the paradigm for good investing using Apple as the model, knowing full well there are not enough Apples in the stock market to build a diversified portfolio. However, the small investor can find enough Apple-like stocks for his portfolio. The portfolio manager's dilemma is solved by compromise and buying the best stocks in each sector. Some of them will not look very attractive compared to Apple. This chapter illustrated how to use technicals with fundamentals to improve performance by picking high performance stocks in the Dow 30 list of stocks. Buy and sell signals were illustrated using Home Depot (HD) and Wal-Mart (WMT). The Standard & Poors charts for these stocks illustrated the combination of fundamentals and technicals every investor and portfolio manager needs to use and improve upon.

Successful Stock Signals for Traders and Portfolio Managers: Integrating Technical Analysis with Fundamentals to Improve Performance, Thomas K. Lloyd, Sr.

CHAPTER 18

Traders Need Stocks to Trade

Using Candlesticks, Volume, 10-Minute Chart, Stochastic, MACD, and RSI, with Gamestop, Green Mountain Coffee, and JCPenney Exhibits

Traders need the fastest signals available to beat out other traders in front-running stock price movements. The professionals have to beat the day-trading amateurs. To have an edge over all the other traders, they need to use something that is not yet showing up on everybody's screen. Price and volume are real time and all the calculated technical signals are slightly delayed. The challenge for the trader is to convert the raw data of price and volume, and beat the computers calculating the standard technical analysis signals. Before technical analysis signals of today, the old timers just read the tape and manually made notes of significant volume and price changes. Some people have a talent for reading columns of numbers instead of reading charts to determine supply and demand.

The professional trader needs to see the order flow and trade when the very short-term move tops out or bottoms out. To do that, he needs to know when the sellers are done or when the buyers are done for the time being. Since there is no signal for this, the professional trader, like the professional portfolio manager, has to sell before the top becomes apparent and buy before the bottom becomes apparent (in a contrarian manner). This increases risk and profits. Waiting for signals decreases risk and profits in trading, which is probably better for the novice day trader.

The best signals to do this with are the trade-by-trade candlestick chart, support and resistance levels, gaps, volume, reversal signals whether

candlestick, RSI, stochastic, or MACD. Divergences preface reversal signals, such as volume dropping as price rises, indicating underlying weakness. Since the trader can reverse his trading order in seconds, technical analysis signal speed is more important than reliability. If the signal is wrong, the trader quickly reverses his trade and waits for a better opportunity to make up a small trading loss due to the false signal.

Portfolio managers will usually have their own in-house, buy-side traders to protect them and to use technical analysis. Portfolio managers will also avoid the trading traps by selling their whole position at a fixed price below the market price. The Wall Street institutional trading desk then has the challenge of selling the portfolio manager's block of stock. They know how to move the price up and make a profit on a stock with bad news.

TRADERS ARE EARLY BIRDS

Professional traders will try to move ahead of portfolio managers, who may not start executing their portfolio changes until the market opens in the morning. They may have to go to a meeting before acting on the news. The professional traders will be trading ahead of them on news that came out after the market closed which are usually earnings announcements, but it could be any kind of breaking news. Traders will trade around the world before the market opens in New York. You can trade in London in the hours just before New York opens.

New York traders will be at their trading desks a few hours before the New York open. They will know the trades in London and the trades in the aftermarket the night before. They will see the preopen trades in New York and will be able to trade before the market opens. The specialists and market makers will have all of this information as they determine the opening price of each stock in New York based on supply and demand facing them before the open. This is why the opening price in New York will be different than the last price posted in the after-hours market the night before. The opening trades can be rocky because not all trades are rational. For example, margin call orders on the open are irrational forced selling, or buying to close accounts with margin calls. The brokerage firms doing the margin calls could care less about the execution price because it isn't their money but their customer's money. However, the portfolio managers will be creating the important source of that supply and demand before the open and throughout the trading day. Traders will find out what the portfolio managers are doing. That is what you have to find out by using technical analysis.

The high-frequency trading (HFT) programs will be creating most of the volume throughout the day and the illusion of liquidity. Day traders and hedge funds will join in, but the price trend over time will be determined by the portfolio managers. The traders and HFT programs will be playing around the portfolio manager's buy and sell orders. Those buying and selling options will also be influencing demand and supply. Sometimes, these option trades in Chicago are determining the price of stocks in New York and not vice versa. Changes in option prices can be leading indicators to changes in stock prices. As we have noted many times, leading indicators are the most valuable signals for any trader.

TRADERS ARE OPPORTUNISTIC

Traders will have plenty of opportunities each day based on surprises and breaking news. They are looking for the news to create grossly inefficient prices, as emotional buying and selling will move prices to extremely overbought and oversold points. In a contrarian manner, they will sell short extremely overbought and buy extremely oversold prices. They will also play momentum if price is going to keep moving in one direction all day long with no pullbacks or bounces. They won't fight the tape if price is going straight up or straight down, as frequently happens after shocking surprises.

When there are no special situations created by breaking news, traders will act much as the old specialists and market makers in stocks that they follow every day and know very well. The disadvantage of using breaking news stories is that you have to trade stocks that you are not familiar with and don't know their normal trading patterns. Obviously, the specialist or market maker in a stock that has breaking news has the advantage of knowing that stock's behavior intimately. He or she knows the big buyers and sellers that will come out of the woodwork on the news. The trader new to the stock, trading it for the first time because it is a stock in the news is at a real disadvantage. He is trading the stock purely on technicals and has no insider edge about the trading pattern of the stock other than what he can see on the chart historically. There is no way a day trader can come into a stock cold and beat the trade timing of the professionals.

In fact, some day traders will only trade stocks that they camp out on every day and know as well as the specialist and market maker. How they select these stocks may be a matter of past experience. If you read Internet posts on boards, you will often find one of these traders monopolizing the board. They are there day in and day out, and that does give them an advantage. Sometimes, they are even employees of the company and know

a great deal about the company culture but no illegal inside information. Those with inside information do not post on bulletin boards or give tips to the media, unless they want to create a trading stampede to cover their own illegal trading.

TRADERS HAVE A LIST OF LONGS AND SHORTS

Most traders have a list of favorite long and shorts that they check every day to see if there is one they would like to trade. They may not like the risk and speed of trading the treacherous cross currents of a stock with breaking news. Here, we are going to illustrate a way of preparing a list of longs and shorts selected from the S&P 500 list using the program I like to use. You can use any scanning program such as Value Line, VectorVest, Zacks, IBD or many others available to the public.

For the longs, we will pick stocks with top-rated fundamental and forecast scores, with particular attention to the analyst revision model which identifies stocks in the news recently, usually because of earnings. We will do the same for shorts, except we will look for the worst stocks. We will review this list each day, looking for trades and picking those trades that would be helped by the S&P 500 market move up or down each day. On good days, we will select a long, and on bad market days, we will select a short and watch what the chart does throughout the day. In a sense, we will be front-running the portfolio managers who are buying and selling these stocks because of the good and bad fundamentals and forecast data and recent analyst revisions up and down. A recent change in the analyst revision model indicates new reasons for portfolio managers to be buying or selling these stocks.

GAMESTOP ON THE LONG LIST BUT IT'S A TRADING SHORT

Gamestop (GME) was one of the stocks selected as a long by my scanning program, but the chart indicates it is probably a trading short. Traders love to be contrarians, and when they see a good long extremely overbought, they will short it, once the tape shows signs of weakness. Exhibit 18.1 shows Gamestop to be in an outperforming "buy" at (1), an uptrend at (2), positive money flow at (3), but the money flow index (MFI) and relative strength index (RSI) overbought/oversold oscillators at (C) show it to be overbought. Gamestop has had an enormous 33 percent run up in price

EXHIBIT 18.1 GME, November 26, 2012, Daily
Source: StockCharts.com.

from $21 to $27.74 in only 10 days starting at (A). In Exhibit 18.1, points (1), (2), and (3) are the long-term buy signals. Points (A) and (B) are the short-term buy signals.

For the first time in 10 days, there is a negative red candlestick, on Friday, November 23, 2012, at (D), followed by more selling on Monday,

November 26. The red candlestick ran up to $27.74 and failed, thus indicating the buyers were exhausted at (D); it dropped to close below the opening price thus forming the red candlestick body. This profile candlestick is a shooting star reversal signal. In other words, the unusual run-up appears to be over. On Monday, the selling continues, confirming that the buyers on balance have stopped and are waiting for lower prices. The selling comes as no surprise to the overbought signals in green at the two points identified as (C).

Traders will surely recognize the buy signals at (A) and the sell signals at (D) and trade accordingly. Trading long at (A) is much safer than short selling at (C). The candlestick buy signals at (A) consist of a reversal doji, followed by a big white candlestick. The doji is in red and looks like a star point. A very small red body indicates that price opened and closed very close to each other. The long wicks (lines) below and above the body indicate that the buyers took price up and sellers took it down during the day but nobody won and the buyers and sellers were in equilibrium at the end of the day. This doji signal is a reversal signal and suggests the downward movement in price may be over because the sellers are gone and the buyers have arrived.

Sure enough, the following day shows a big white candle, a big jump in price. The buyers have taken over. All the other signals on the chart confirm this buying. Money flow goes into the green; spikes in volume confirm buying shown in price; relative strength is moving up, and the oscillators are moving up. The trader knows it is time to buy. During each day of the move up, he or she would buy every pullback knowing from volume and price that this is a strong move up.

A quick check of Nasdaq.com shows that 8 of 17 analysts have GME as a buy. The consensus 12-month target is only $29.50. It is understandable that the recent high of $27.74 was too close to the $29.50 target to make much sense for the short term and price turned down.

The holiday season, including Black Friday sales, was obviously influencing the price. Technicians are not interested in any of this and are only watching demand and supply. The technical indicators show it is overbought and supply is taking price down to test support. For the day trader, this is a short. The day trader would lean to shorting every bounce up during the day.

Exhibit 18.2 is a 5-day chart showing the price peaking at $27.39 on Friday, November 23, 2012, followed by selling late on Friday and continued on Monday. The signals below the chart are dropping. RSI and stochastic are dropping from overbought flashing their sell signals. In fact, the stochastic puts in a sell signal, breaking below 80 on the scale, as price puts a new high in place at $27.39 on Friday. The CMF on Monday is dropping after peaking with price going to $26.97. The day trader would be shorting Monday's top at $26.98.

EXHIBIT 18.2 GME, November 26, 2012, 4-Day, 15 Minutes
Source: StockCharts.com.

The day trader will be happy to make 10 cents off these tops. He will be careful because he is shorting a stock that is rated a buy both technically and fundamentally. He is playing the short-term exhaustion of buyers and the overbought signals. Notice how light the volume is on Monday, November 26, in Exhibit 18.2. At noon on Monday all the signals turn positive except CMF, which improves late in the day. The stochastic turns up from oversold at around 11:30 A.M. RSI turns up at the same time. There is a positive crossover as plus D1 moves above minus D1 at 12 P.M. Price turns up in the afternoon. Any good news on holiday sales could bounce price right back up, but that is not happening on Monday, November 26.

As we have stressed in the past, the most important signals for the portfolio manager are (1) performance relative strength and (2) the 200-day moving average. Relative strength shows a strong uptrend, meaning this stock is outperforming the S&P 500 Index and portfolio managers need stocks that outperform the index. Likewise, they want to be in long-term uptrend stocks as shown by the uptrend in the 200-day moving average. Traders look at these long-term signals to classify the stock as a long or a short on their watch lists.

They want stocks that bounce up nicely after testing the 200-day moving average and that is exactly what happens at point (A) on Exhibit 18.1. This bounce up is a confirming buy signal and gives the portfolio manager a reliable signal that the uptrend will continue. The portfolio manager will not be too concerned about the pullback sell signal at (D). The portfolio managers will wait for price to drop so they can buy more on weakness. This pattern is well known by traders, and they will trade accordingly.

Just to summarize, we scanned the S&P 500 stocks to find good fundamentals and recent positive analyst moves to provide a stock for our trading list that we could trade to the upside. Gamestop was selected by the scan, plus a few others. It turned out to be a nice outperformer with an attractive uptrend in price. Unfortunately, the timing was bad as all the good news was already in the price and short term it was overbought.

It provided a trading opportunity to the downside to retest support. However, this belongs on the trader's long list to trade the next move up. The strategy here is to front-run portfolio managers when they start buying again on weakness. The previous high in price (resistance) was around $24. That now becomes support and the target for this pullback. The trader would be looking for that support at $24 to hold and would use the signals on Exhibit 18.1 to time his buy as the signals turn up again from oversold to retest resistance at the most recent high of $27. Now let's turn to an example of a breaking news story on Green Mountain for day trading.

TRADING THE POSITIVE SURPRISE IN GREEN MOUNTAIN COFFEE

Professional traders prefer to play the major surprises in earnings announcements. Novice traders will also play them because it is the only time they have a level playing field with the professionals. Green Mountain Coffee had a positive surprise and jumped 26 percent in the after-hours trading, once earnings were announced after the close on Tuesday, November 27, 2012. Here is the article I wrote on Tuesday night titled "Green Mountain Coffee Surprises the Shorts." It was published on MarketWatch.com's "Trading Deck"on Wednesday at 8:16 A.M. EST, before the market opened. After such an enormous jump in price, traders, who love to be contrarians, would be inclined to short this move up expecting the gap up to be filled by price going back down to retrace the gap up. However, if the buying continued on Wednesday the traders would certainly not fight the tape.

Green Mountain Coffee surprised the shorts and the price jumped 26% to a high of $36.50 after hours following positive surprises in earnings and forecast.

With 50 million shares short, about 9.5 trading days' worth and 42% of the float being short, there may be a bit of a scramble to buy on Wednesday. Where is the next resistance level above $36.50? On the Point & Figure Chart it looks like $42. The weekly price chart shows resistance at $38–$40, although a slim case could be made for the breakdown point at $50. Last May 3 it fell from $50 to $26. If there is a short squeeze, price could see a reversal of that move down.

If there is no short squeeze, then price will go up according to the new fundamentals just revealed by GMCR's earnings announcement. A quick check shows that the 16 computer models had GMCR as a four star buy as of last Friday and obviously before the positive surprise in earnings. The total score for GMCR is 6 where 3 is best and 30 is worst. This is the adjusted score when we compare GMCR to the growth universe of stocks instead of the complete universe of 8,000 stocks. This score includes equal weighting for fundamentals, forecast and technicals.

What is the 12-month price target for GMCR? Yahoo.com has it at $38.55. Nasdaq.com shows consensus at $39. Finviz.com pegs the target price at $37.27. If you apply a PE of 15 to the lower part of the company forecast in earnings you come up with a target of $39. All of these price targets are close to the price resistance of $38–$40

showing on the chart. It is not unusual for price to test a 12–month target before falling back to test support again.

It is possible that price will open on Wednesday below $35. It may go lower instead of higher if the shorts are adamant or desperate to take price lower so they can cover. There could be a reiteration of the bear case in the media and a repudiation of the latest earnings, which, while very positive, change nothing in the bear case.

Basically, K-cups are off patent, competition is increasing, deals with Starbucks, Dunkin and Costco may not last, and growth and margins are still declining. This is just a dead cat bounce, a technical blip and another opportunity to short at higher prices. With growth and margins declining and negative free cash flow for the latest quarter, a PE of 10 may be right for the earnings forecast giving a target of $26–$27. Price is up only because of a little panic short covering after hours.

Take your pick. Watch the open. See if the price heads back to $29 or reaches for $39. The tape will always tell you which way to trade. Price and volume do not lie, but there are always headfakes.

Note: Nothing in this article is meant to recommend GMCR as either a long or short (buy or sell) nor encourage risky trading. Consult with a professional financial adviser before acting on information in this article.

Exhibit 18.3 shows what happened to price on Wednesday. As you can see it went higher on the day opening at $34.55 and reaching a high of $37.48 for a trade of almost 3 points. Any day trader would have been happy with 50 cents of that trade. The big question remaining is whether price would drop to partially fill the enormous gap up in price from $28.95 to $34.55. Regardless, there was now a substantial long-term buy signal for GMCR on the chart both in volume and price.

As suspected in my article, the stock did open lower than the after-hours close on Tuesday. But even though it opened lower on Wednesday, price and volume quickly moved up and signaled to the trader to buy at $35 for a test of the previous night's high of $36.50. As I indicated in my article, price and volume do not lie, and they would show you how to trade after the open.

At around 10:30 A.M., price was stopped at $36.35. It moved sideways until after lunch at 1 P.M. and started a move up to the high around 3:30 P.M. of $37.48, when day traders call it quits and settle before the 4 P.M. close. A day trade from $35 to $37 was quite doable and that is a fantastic and rare paycheck for any day trader. More than likely, the day trader would be in at $35 out at $36 then back in after lunch at $36.50 and out at $37. It is

EXHIBIT 18.3 GMCR, November 28, 2012, 3-Day, 10 Minutes
Source: StockCharts.com.

impossible to catch tops and bottoms consistently unless you are a professional. Many ex–market makers are out there, trading their own personal accounts. If you know one, have him or her teach you day trading.

WHY NO SHORT SQUEEZE IN GREEN MOUNTAIN COFFEE?

A major short squeeze would have taken price up to $50 and with all the shorts you have to wonder why a major short squeeze did not develop. Obviously, some of the shorts are not worried because at some time in the future they will come into possession of the stock and they already have their short position covered. Likewise, major short players are long-term hedge fund managers, not short-term traders. Typically, they don't have to worry about margin calls like the novice trader who shorted Green Mountain Coffee.

They may have shorted Green Mountain Coffee because they expect it to go out of business or because they no longer have a patent monopoly and the competition will eat them alive. They will ignore the short-term dead cat bounce up and wait for the long-term demise of Green Mountain Coffee. They have done an enormous amount of research to come to this conclusion. A price jump in Green Mountain Coffee will not panic them into buying to cover their short position.

PREPARING A TRADER'S SHORT LIST

Every day will not provide a gold mine for day trading such as Green Mountain Coffee did. For the dull news days, the day trader has a list of longs and shorts he is watching. We discovered Gamestop for the trader's long list, which we found by scanning the S&P 500 for good longs. Now we are going to scan the 500 to find some shorts. Here, we want stocks with poor fundamentals and forecasts. In addition, we want recent downgrades by the analyst revisions model meaning there is some recent bad news.

The scan produced a list of about 40 stocks and JCPenney was on the list. This short was no secret to anyone at this point. It had dropped dramatically in 2012 from a high of $42.94 to a low of $15.69 and was currently at $17.94, as shown on Exhibit 18.4. Traders have had this on their short list for some time. As you can see on the chart, there is no bottom in place yet. It could have started putting a bottom in place at $20 where we have drawn the blue support line. Unfortunately, price just broke through that level on its way down to $15.69 and $20 now becomes the resistance line.

EXHIBIT 18.4 JCP, November 30, 2012, Weekly
Source: StockCharts.com.

On the chart, we identify the downtrend in price by drawing the downtrend line in blue connecting the lower tops in price. Also we use blue down arrows to identify the long-term downtrend in performance relative strength and in the 200-day moving average. There is no question this is a continuing short and no sign these downtrends are changing. As a result, the trader will continue to sell short every bounce up.

Price is bouncing up for the latest two weeks in Exhibit 18.4, and there is a blue arrow pointed up just under price. Price is at $17.94 bouncing up from $15.69, and it is targeting upside resistance, possibly at $20, where the blue line is drawn. It may also be targeting a test of the 50-day moving average at price label $22.16 on the chart, or the 200-day moving average at $26.91, or the blue downtrend line just below $25. All of these appear on the price chart.

It is quite possible that this dead cat bounce up will fail at any time and never reach $20 or any of the other signals that identify resistance. The day trader has it on his short list and is waiting for this bounce up to fail, so that he can short it for the trip back down to test $15.69. Since there is no bottom in place yet, price could break below that level just as it broke below $20.

Blue arrows that are pointed up in Exhibit 18.4 show the short-term signals turning up during this short buying cycle that is taking price up to test resistance. This looks like a bounce from oversold. You can see that the stochastic is oversold and starting to turn up. Likewise, OBV, relative strength, and money flow are turning up, but there is no indication that these signals will turn from negative to positive. Since this is a weekly chart, the day trader would turn to the daily chart and the 5-minute chart to determine when the bounce up is over and it is relatively safe to start shorting the stock again for the trip down to test $15.69.

SUMMARY

Typically, the day trader will trade breaking news of the day on any stock, and we illustrated that using Green Mountain Coffee (GMCR) and the technical analysis signals for trading. On days when there is no breaking news of interest to the trader, there will be his list of favorite shorts and longs to trade. We illustrated how to scan the S&P 500 list to come up with a trading list of longs and shorts. Gamestop (GME) was selected as a long, and JCPenney (JCP) was selected as a short, and the technical analysis signals for trading were exhibited.

Successful Stock Signals for Traders and Portfolio Managers: Integrating Technical Analysis with Fundamentals to Improve Performance, Thomas K. Lloyd, Sr.

CHAPTER 19

Winning in the Stock Market Using Technical Analysis, S&P 500 Index, SPY, and Reading the Market, with SPY Exhibits

Whether you are a professional portfolio manager or professional trader, you can improve your performance by sharpening your technical analysis skills. The professional trader is constantly trying to move ahead of the widely known and used technical signals. The portfolio manager has no such need. He and any investor can use existing technical signals to improve performance.

In this chapter, we summarize how the trader and the investor can use technical analysis. These are the important points and examples to take from this book. We will use chart examples that will have long-term interest for the investor and short-term interest for the trader. You can pin these charts up on your computer wallpaper and look for the signals we describe in the coming years. They are recurring, just as the waves breaking on the beach. The trader rides the waves of demand or supply just ahead of the wave. The portfolio manager waits for the wave to crash on the beach with a resounding buy or sell signal. The trader and the portfolio manager use technical analysis in very different ways, but the end result is the same in achieving better performance.

Both traders and portfolio managers must be able to identify and use the technical analysis signals for the broad market such as the Standard

& Poors (S&P) 500 Index. Here, we look at the market both from the long-term investor's point of view and the short-term trader's objectives. Fundamental investors may block on technical analysis when it comes to individual stocks because of their fundamental bias. But portfolio managers and long-term fundamental investors seem to have no such prejudice when viewing charts of the stock market. It is a mystery to me why they use technical analysis on market charts but are reluctant to do so with stock charts.

This chapter is at the end of the book just in case the fundamental investor has spent most of this book fighting the benefits of technical analysis. Hopefully, this is the chapter where the scales drop from their eyes, the blindness ceases and the light finally comes on that technical analysis adds value to fundamental analysis. It helps to improve performance, not because technical analysis has some arcane secrets for success, but rather that technical analysis is the only way to measure supply and demand, which moves stock prices and the market. Fundamental analysis may do many things, but it cannot measure supply and demand that is moving prices. If fundamental analysis is the first step for every investor then technical analysis is the first step to improve investing performance. When it comes to analyzing the broader market movements, technical analysis may be the only option for the fundamental investor and perhaps that is why they look at charts when looking at the S&P 500 Index.

WHAT IS THE CURRENT STATUS OF THE MARKET?

This is the first question every trader and every investor asks himself every day. There is no easy answer, and technical analysis does not provide any prediction of the future. Technical analysis tells you exactly where demand and supply have taken price up to this very day. In addition, technical analysis can measure supply and demand changes and those signals have a cumulative effect in determining the trend of price. Sell signals tell you that price is going down and buy signals tell you that price is going up. The trend of these signals tells you the trend of price.

Trends have a way of continuing until broken. Technical analysis tells you when the trend is broken. This is very valuable information in the decision-making process, but it is not forecasting or predicting the future. There are just too many exogenous factors that are completely unpredictable that move the market and make it impossible to predict the future. Prices and volume do not lie about supply and demand moving price, and technical analysis does not lie. The factors moving supply and demand may be fallacious, but the movement of price is a fact. Technical analysis measures that fact.

As you can see in Exhibit 19.1, we have gone back to 1993 to answer the question of where the market is on December 3, 2012. Using the S&P 500 SPDRs (SPY) as the surrogate for the market and the S&P 500 Index, you can see the recurring patterns and the buy/sell signals explained in this book to analyze individual stocks. Know Sure Thing (KST) is used because it is especially effective in smoothing long-term trend lines using four different moving averages and weighting the longest average the most. This weighting makes it especially effective in a chart going as far back as 1993.

The weight of evidence in Exhibit 19.1 is overwhelming in identifying enough different buy and sell signals to convince even the most prejudiced that technical analysis adds value to the analysis of any market or any stock. The historical breadth of this chart shows the reliability of technical analysis signals over time. This is the reliability that every portfolio manager and investor needs; technical analysis does fulfill those needs. We will now discuss each of the signals in Exhibit 19.1 in greater detail.

EXHIBIT 19.1 SPY, December 3, 2012, 20-Year, Monthly
Source: StockCharts.com.

ELLIOTT WAVES

In Exhibit 19.1 the first signal that jumps out at you is the count of five Elliott waves to the top. You can see why Elliott wave theory is popular. It seems to correctly count the buying waves to the top. Does this work all the time? No! Will it work this time? Who knows? But looking at this chart, where it has worked two times in the immediate past, you certainly have to wonder whether we are nearing the top of this market.

If nothing else, it sensitizes you to the fact that this market has had a long run. It is vulnerable to a pullback. It reminds you to look at every other signal on this chart for sell signals. It tells you don't be surprised if the market pulls back from this level. It encourages you to act more quickly on any future sell signals. If you see sell signals in the future, it encourages you to believe what you are seeing because the market is overdue for a correction. Will the "fiscal cliff" be the trigger of this correction? Who knows? Technicians aren't really concerned with the answer, but only the sell signals they are now looking for because of the Elliott wave count. If it tells you anything, it tells you the market is vulnerable. Look for sell signals. Act on them quickly. Be prepared and be proactive.

Counting Elliott waves is more of an art than a science. A case could be made that the five waves appear because that is what we are looking to find. Some of the waves are not very distinct. The latest series of waves to the top at $147.32 (near 1,473.2 on the S&P 500) are very distinct and easy to identify until we move to wave 5. Some would see three waves here and not just one. Regardless of how you count the waves, the point is still made that the market seems to be moving close to a top. The caution flag is waving.

USING THE *STOCK TRADER'S ALMANAC*

I use the *Stock Trader's Almanac* and its enormous body of statistics on the market. I can't imagine any investor, trader, or technician not having this reference work on their desktop and writing notes in it every day. The statistical patterns may be disturbed by the *fiscal cliff* items or the beginning of a war or some other world-shaking event. Immediately ahead for the market after this December 3, 2012, chart that we are using are the Santa Claus rally and the continuation of the best six months in the stock market, which ends in April 2013. The first week and the first month of the New Year will supply some statistical insight into 2013. Furthermore, this being the first year of a new presidency also has very distinctive statistical implications for the stock market. Like the Elliott wave theory, the *Stock Trader's Almanac*

provides many statistical insights into the patterns of the market. They sensitize you to look for demand-and-supply signals on the chart. Just as the Elliott wave theory puts you on alert, so will the *Stock Trader's Almanac* every day of the year, without any attempt to predict the future.

If there is going to be a market correction in 2013, you can look for some of the following to occur as negative signals: there is no Santa Claus rally at the end of December 2012; the first week of January is negative; the month of January is negative; the market during the first quarter of 2013 breaks below the December 2012 low. Any of these signals will help you to see more clearly the formation of a top and any correction in 2013, knowing that bad things tend to happen in the first two years of the four-year presidential cycle. The *Stock Trader's Almanac* helps you to be proactive.

IDENTIFYING TOPS IN THE MARKET

The first top in the market on Exhibit 19.1 is the classical and well-known double-top warning that the market may be finished and ready to drop into a correction. It occurs near the price label $124.55 on the chart in 2000. The second top is also the well-known head-and-shoulders top peaking at the price label of $141.53 in 2007 and breaking the right shoulder at around $120. At that point, it has also broken below the previous top of $124.55, a double sell signal, as the market fell to the bottom shown on the chart as $62.

How do you know these are tops when they are happening? With the double top, you don't know until price starts dropping, breaking important support levels and triggering other sell signals on the chart. After the double top appears, you check for sell signals. If after the double top appeared, you checked the percentage price oscillator (PPO) and KST, you would have seen two sell signals already in place warning you to take the double top seriously. If you ignored these two leading indicators, then the concurrent selling shown on moving average convergence divergence (MACD) would have confirmed that the double top was indeed a sell signal.

Likewise, the Keltner channel turns down, but first price violates the dotted median line of the channel for another sell signal. The Keltner channel lines are the ones that surround price as it moves up and down. The median line is the dotted line, exponential moving average between the two channel lines surrounding price. Notice how price, when in an uptrend, fluctuates between the upper channel line and the median line recording deviation from the mean. When price is in a downtrend, it fluctuates between the lower channel line and the median line. These trends change when the market is changing trends from bull to bear or bear to

bull. Therefore, moves above the median line or below the median line are important signals. Unfortunately, these breaks are sometimes false signals of change and they quickly reverse. Using the weight of evidence approach avoids dependency on one signal and avoids the false signal problem.

IS THIS A MARKET TOP?

As of December 3, 2012, the market has not put in place a double top or a discernible head-and-shoulders top. (It could turn out to be a triple top or an inverted "V" top.) The KST signal has turned negative but not a clear sell signal yet. The KST and the Elliott wave count of five have put you on notice to watch for further sell signals and the formation of a top in price. The PPO and MACD are weak and tentative, but no sell signals yet.

The Keltner channel lines are still very positive and price has not violated the median line, which is still in an uptrend. A break below $134 would be an important sell signal. Price is putting in place new highs, but any failure to stay above the 2007 top of $141.53 would be an early sell signal. The break below $134 would confirm that sell signal and confirm the long awaited correction is probably underway. The fiscal cliff is not the only possible trigger of a correction. A war with Syria or Iran would also trigger a correction, as would any other major negative world event.

For those looking for the positive case scenario, there could be an Elliott wave "a, b, c move" down back to $134 where support holds. Then there is the start of another five waves up to another top. That would require a solution to the fiscal cliff, no wars, no Euro breakup, no default by Greece or Spain, no deep recession in Europe, no recession in the United States or China, and improvement in unemployment and housing in the United States. The creation of a new growth industry, like the Internet, would help. Whatever happens, technicians will see the buy or sell signals on the chart, without necessarily knowing all the reasons. Technicians will not be analyzing these world events but will concentrate on the buy or sell signals they create on the chart. The technician is watching demand and supply on the chart.

PERCENTAGE PRICE OSCILLATOR'S BUY/SELL SIGNALS

At the top of Exhibit 19.1 is the PPO momentum signal with the buy and sell signals labeled. As you can see, this signal turns negative in 1998 and remains negative, heading down in 1999 and 2000 when the double top forms. Portfolio managers need early signals such as these. For a stock like

Apple, which is owned by an enormous number of portfolio managers, an early signal is critical so that you have enough time to sell and not disturb the market price of the stock. Portfolio managers want to be selling into strength. They don't all want to head for the exit door, all at the same time when someone yells "fire!"

Likewise, if they are going to switch from the high-beta stocks of a bull market to the defensive position of low beta stocks of a bear market, the portfolio manager needs time to make this transition. Early sell signals alert him to the coming market top and give him time to transition from risk on to risk off. Don't forget, we are looking for the weight of evidence in sell signals, and the first and earliest sell signals are a *heads-up*, not a decision maker to sell. The MACD and the double top in price will provide the timely sell signals just before the market falls into a correction.

In the second top, during 2007 at $141.53, the PPO sell signal is not early and breaks down with price in 2008. (This is probably what will happen for the correction signals we are waiting for now.) However, it does give an earlier signal than the breakdown of the right shoulder sell signal in price. The PPO sell signal warns you that this is going to be a head-and-shoulders top and to expect the breakdown of the right shoulder for a confirmed sell signal. The correction is well under way after the right shoulder breakdown in price. The question is: will the PPO signal be early in 2013? If it is not early, then you will see all the sell signals turning down at the same time.

The PPO also gives a timely buy signal in 2003 as the first Elliott wave starts its move up and is labeled with a blue "1" on the chart. This buy signal is confirmed by the MACD buy signal and the KST signal to flash the weight of evidence overall buy signal. These positive signals would definitely help to overcome the fear of the market falling still more. These buy signals confirmed that the double bottom was in place and this was the first of the Elliott waves going up. The same buy signals are flashed in 2009 as the market again puts in place the first Elliott wave going up.

In general, the PPO (dark black line) gives three types of signals: crossovers with the signal line which is the 9-period exponential moving average (9EMA), crossover with the zero horizontal line and negative or positive divergences. The PPO on December 3, 2012, is positive above +5 on the scale. At the beginning of Exhibit 19.1 you can see that the PPO is almost to 15, extremely positive, when it breaks to the downside starting the long trip down. The downward direction for almost two years before the crash is a negative divergence. Price keeps going up while the PPO keeps going down. The PPO crossover at the zero horizontal line is a late signal and the correction is well under way by the time of this negative crossover. However, the exact sell timing is somewhere between the time the PPO turns down and the time it crosses over at the zero line.

On the right-hand side of the chart, you can see that the latest reading of the PPO is 5.41, positive, and it can stay positive for some time. You can also see the histogram below has flat-lined. That is because the red signal line (9EMA) is right on top of the PPO (dark line). The histogram bars above and below the horizontal line are formed by the difference between these two lines, which are hugging each other. By scanning across the chart you can see when the bars of the histogram drop sharply below the horizontal line; it is a sell signal. That will happen when the PPO breaks sharply to the downside, creating a big difference between the fast-moving PPO black line and the slower-moving 9EMA red line. The PPO line is simply the difference between the 12EMA and the 26EMA converted to a percentage of the larger 26EMA. By converting to a percentage you can compare stocks regardless of absolute price. Thus, you can compare a $30 stock with a $500 stock, and there will be no distortion. This is an improvement over the MACD, which uses absolute numbers rather than a percentage calculation.

MOVING AVERAGE CONVERGENCE DIVERGENCE'S BUY/SELL SIGNALS

The MACD calculation is the same as the PPO with the exception that the PPO is converted to a percentage calculation, while the MACD is calculated based on the absolute numbers. In Exhibit 19.1, we show only the MACD histogram, which is the difference between the MACD and the slower moving 9EMA. As you can see this histogram gives a more dramatic sell signal or buy signal than the PPO histogram.

Exhibit 19.1 shows that in 2011 you had a slight breakdown in the histogram as the bars dropped slightly below the zero line. The sell signal we are looking for that would indicate the start of a correction is a sharp drop in these bars below the line indicating that the faster moving MACD line is dropping sharply below the slower-moving 9EMA.

If you scan across Exhibit 19.1 for the MACD signal, you will see that we have labeled each sharp drop of the histogram below the line as a sell signal. Each break above the zero horizontal line by the histogram bars is shown as a buy signal. You can see how these signals correspond to the price movements shown on the chart.

The MACD turns out to be an excellent concurrent signal at the start of a major bull or bear market move. It is a timely signal useful for both the portfolio manager and the trader. As we have mentioned, the portfolio manager prefers early signals to concurrent signals. The trader prefers timely signals because early signals will break the trader. You can go broke being right about the stock but wrong in your timing. Signals that are too

early are just as bad as wrong signals for the trader. The trader wants to be ahead of every other trader in terms of minutes not months. The portfolio manager needs months to unwind his position or accumulate a new one.

KNOW SURE THING BUY/SELL SIGNALS

KST is found at the bottom of Exhibit 19.1, and the crossover buy and sell signals are identified and easily compared with price movements on the chart. It gives its first sell signal in 1998, continues down in 1999, and moves sharply down in 2000 as the double top is put into place and the market starts its correction. At the next top in 2007, KST provides no lead time, and the sell signal is concurrent with the fall in price as the bear market begins. It is still a valuable, timely signal in 2007. It just does not give the portfolio manager the time he needs before the market correction starts.

KST is the sum of four different rate of change (ROC) for 10, 15, 20, and 30 periods of time. These are smoothed with 10-period exponential moving averages (10EMA) except for the 30-period ROC, which uses a 15EMA. Each calculation is weighted 1, 2, 3, and 4. The longest period, the 30 period, receives the 4 times weighting. As you can see, this provides a very smooth and reliable signal with no reversals. This is the type of signal a portfolio manager needs. The buy and sell signals are identified on the chart where the KST signal breaks above or below the 9EMA.

As we indicated earlier, the latest KST signal is providing the first *heads-up* sell signal but not the decisive, weight-of-the-evidence sell signal you look for and want. This just confirms what the Elliott waves are telling you on December 3, 2012. Look for the formation of a top and other sell signals to convince that the correction has started. As of this date, there is no sign of a top and no other sell signals in place. In fact, on the Keltner channels, everything looks great, but this is a lagging indicator. Seasonally, the market is in a strong period, looking for a Santa Claus rally and at the same time enjoying the best six months in the stock market between November and April.

KELTNER CHANNELS BUY/SELL SIGNALS

Keltner channels nicely identify the uptrends and downtrends in price. Violation of the channels provides negative and positive signals. They also indicate extremes in buying and selling, in demand and supply. The channel lines surrounding price are calculated based on the 20-period exponential moving average (20EMA) you see as a dotted line between the lower and

upper channel lines. The KELT signals are usually lagging, but nevertheless are very valuable. Many times market participants won't believe the buy or sell signals on the chart. When a laggard signal issues a buy and sell, the most stubborn bull or bear has to give in and recognize the change in the market. He will be late bailing out, but at least he won't crash and burn at the bottom.

When the median line turns from an uptrend to a downtrend and the channel lines likewise change direction, it is very obvious on the chart and a very compelling signal to any doubting Thomas. But before the median and channel lines change direction, price gives an early signal by violating the median line to the upside or downside. Thus, if you look at the median line at every top and every bottom in Exhibit 19.1, you will see price moving from one channel line to the median line, breaking the median line and going all the way to the other channel line. This is an excellent confirming signal that the bull or bear market is now over.

You will see in Exhibit 19.1, all the way over on the right where the latest price and signals are, that price is moving up nicely along the upper channel which is in an uptrend. The median line is in an uptrend and price comes down every so often to test the uptrend. However, price has not broken down below the median line all the way to the lower channel. That is the sell signal that will mark the beginning of the correction to the downside. Although this signal is late, it is reliable and will have appeal to the portfolio manager who wants a reliable but late signal that the market has just changed from bull to bear or vice versa.

The starting point for calculating the KELT is the 20EMA that forms the dotted line in the middle of the channel. The upper and lower channels are two times the average true range (ATR) of price. This range is usually the high/low range of the period and averaged for 14 periods. If you can obtain a larger range by using the previous close, then that will be used. Likewise, if price drops from the previous close, the low of the day may give the largest absolute number and that is what we are after in computing true range. It doesn't matter if the number is up or down, because only the absolute range matters. The Keltner channels lack the disconcerting wild swings of the Bollinger bands.

CLOSER VIEW OF THE MONTHLY CHART

Exhibit 19.2 gives a closer view of the monthly chart, and the signals are easy to see and read for the past 10 years. At the top of the chart we show both the MACD line and the histogram. You can see the word *sell* on the chart as you approach the breakdown in the MACD line and histogram.

Then we draw the red sell line down from the histogram to price $131. At this point, the MACD line and histogram have well-defined sell signals, and the 2-month bounce up to $131 should be used to sell into strength before the market continues its crash.

EXHIBIT 19.2 SPY, December 3, 2012, 10-Year, Monthly
Source: StockCharts.com.

At the top of the chart, you can see that money flow in the green is dropping sharply as price drops. Spikes in selling volume at the bottom of the price chart are confirming the sellers are in control. One of the reasons we use the SPY as a surrogate of the S&P 500 Index is that it trades like a stock and has important volume signals.

You can see the leading indicators, the overbought signals RSI and full stochastic flashing sell signals as both break down through the overbought lines (70 for RSI and 80 for stochastic) as price drops from the $141 top in the fourth quarter of 2007. OBV also starts dropping dramatically. The bottom is reached in the first quarter of 2009, and the leading indicator signals begin to turn up.

In Exhibit 19.2, OBV turns up in the first quarter of 2009. The oversold signals RSI and stochastic break to the upside in the second quarter. In the third quarter we show the word *buy* in blue and a blue line connecting the MACD line buy signal and the histogram buy signal with price. The Chaikin Money Flow (CMF) also turns up but never reflects the very strong move up in price confirmed by volume.

Notice on the stochastic in Exhibit 19.2, there are five waves shadowing the five Elliott waves in price. When you see the fifth wave in the stochastic in December 2012, you will notice that it has not broken down yet for a sell signal. This is a reason for considering the fifth Elliott wave as one wave and not multiple waves as seen in price. The failure of the fifth stochastic wave to break down from overbought would seem to support the thesis that the fifth Elliott wave is still in place and that is the valid count of the Elliott waves.

The important question now is: will the breakdown in the stochastic from overbought be the start of the next correction? It will be an important sell signal. You can see on the chart that you have a blue question mark at the RSI overbought signal. It has not gone above the 70 line into the green and overbought territory yet. It does not have to because it could fall right from where it is. But if it does go up into the green, it will be a sign of price strength and you will have to wait for a break to the downside to see price weakness again and a sell signal. Maybe this is why the stochastic signal has not broken down yet sending out its sell signal.

Finally, looking at Exhibit 19.2 and the OBV signal, you will see the negative fan lines that are in place. OBV is weakening. The stochastic is overbought and vulnerable to a breakdown. The CMF is still in the green at the top of the chart but it is weakening and dropping. The fifth Elliott wave means price is vulnerable to a correction. There are no sell signals but many yellow flags flying. The lagging Keltner channels remain in a bullish uptrend unconcerned about the yellow flags. It reflects the overoptimism of the market in the face of serious exogenous challenges in 2013.

SWITCHING TO THE WEEKLY CHART (EXHIBIT 19.3)

With the eagle-like overview that the monthly charts provide the portfolio manager, we now switch to the weekly chart, which is the working tool of the portfolio manager and investor. Our search is for reliable, long-term signals for the portfolio manager and investor. We will switch to the traders later, using the shorter-term daily and intraday charts.

The purpose of the weekly chart is to give the portfolio manager or investor an early warning that the signals on the monthly chart will change. There are no sell signals on the monthly chart. Are there any on the weekly chart? As you can see in Exhibit 19.3, there are no major sell signals on the weekly chart. We show some short-term buy and sell signals, but these are just the short-term cycles playing out as price goes down to test the 200-day uptrend. The latest test shows that uptrend still intact. Price is now bouncing up from oversold to see if it can put a new high in place with the Santa Claus rally or perhaps an agreement on the fiscal cliff. Not only is the 200-day uptrend still intact but the pattern of higher highs and higher lows is still intact. The next challenge for the market is to put in the higher high. A triple top at $147 will be an anathema if it happens.

At the top of the Exhibit 19.3 you can see the short-term sell signals that are in place for the MACD. We draw a red line down from the short-term sell signal as the bars of the histogram break below the horizontal line and the black line, MACD indicator, breaks below the signal line, which is the 9EMA of the MACD black line. From the red line drawn down to price, you can see price is well into the pullback heading for a test of the 200-day. The test holds and bounces, thus no problem. The important question now is: how high will price bounce up? The stochastic clearly shows this bounce up as it moves from oversold to back up to overbought. Although this signal is moving up, it could abort at any time. At the top of the chart, the MACD does not have a buy signal yet and we show a blue question mark waiting for this positive signal to appear. The MACD histogram is improving as the bars move up.

On the weekly chart (Exhibit 19.3), price puts a double top in place at $147.32 at the end of September 2012. The sell signals shown on the chart fall quickly into place; the correction to the downside starts. The RSI starts falling before the sell signal is put in place. This is circled in red. The MACD and histogram start falling before the sell signal line in red is drawn down to price. Thus, with a double top in place followed by the falling MACD, RSI, and stochastic, the weight of evidence indicated the selloff was under way and the likely target was another test of the 200-day moving average uptrend. The violation of the 50-day moving average, lining up with the red sell line drawn down the page confirms the intention of price to test the 200-day.

EXHIBIT 19.3 SPY, December 6, 2012, Weekly
Source: StockCharts.com.

Now, at the extreme right of the chart, the reverse is happening and the stochastic has turned up marked with a blue up arrow. CMF is in the green still and has turned up. The MACD histogram is improving. At the bottom of the chart, the ADX directional shows the green line moving up (plus D1) and will probably cross over the red line (minus D1) for a buy signal. You are waiting for this crossover, as well as the MACD crossover, where we have a blue question mark.

Despite the increasing volume as price went down to test the 200-day moving average, there is still no sell signal early warning for the monthly chart. The weekly chart is giving you about the same answer as the monthly chart, which is good news. Now we move to the daily chart to see if it gives any early negative signals that might later appear on the weekly and monthly charts. The daily chart provides the overview for the trader just as the monthly chart provides the overview for the portfolio manager.

THE DAILY CHART EVERYONE USES FIRST

Most times when investors or traders pull up a chart, it will be the daily chart they are looking at, and it appears as Exhibit 19.4. Again, you are looking for early sell signals or buy signals that might give an early warning to future changes on the weekly or monthly charts. For the day trader, this is his overview chart.

As you can see in Exhibit 19.4, there were plenty of sell signals preparing you for the drop in price in the S&P 500 Index to test the 200-day moving average. The KST, MACD, RSI, and stochastic gave very early signals that the bearish triple top (double top on the weekly chart) would take price down.CMF was exactly right, turning red and breaking below the line just before the third top was put in place. Likewise, the Aroon oscillator turned bearish just days before the third top was put in place, and this is a lagging indicator! The drop from $147 to $134 should have come as no surprise to anyone. Important support levels at $142 and $138 were broken.

All these sell signals on the daily chart are warning that the weekly chart could soon see major sell signals. The triple top and the breaking of important support levels down to $134 indicate that a market could be topping out with the first leg down in place. The bounce up has failed to break above important resistance at $142. It is warning of the start of a second leg down, which would confirm the market has started a correction by putting a lower high in place.

On the bounce up from the bottom in December 2012, price broke positively above the pivot point (P) at $140, circled in blue. The KST, MACD, RSI, and stochastic buy signals appeared on the chart identified with blue

EXHIBIT 19.4 SPY, December 6, 2012, Daily
Source: StockCharts.com.

up arrows. The break above the pivot point is a short-term positive, but price has to stay above (P).

It may be difficult to put a new higher high in place above $148, and that would be a bearish signal. Volume also needs to kick in with some spikes up. So far, the move up is on weak volume underneath the price showing the gaps up on the chart. Usually, the gap up would have a spike in volume. The MACD histogram, with the question mark in blue, needs to show back-to-back buying cycles without the bars breaking below the horizontal line.

The fiscal cliff will be a drag on the market until it is resolved. Failure to do so would be a big negative surprise to the market charts. The market expects good news on the fiscal cliff. If it does not receive that good news, there will be a market selloff and it will trigger at least a test of the 200-day uptrend. A violation of the 200-day, that does not correct on a bounce back up to the 200-day, along with a triple top that was not corrected by a move above the triple top, would certainly trigger other sell signals on the chart. This would be the expected correction. Sell signals would start appearing in the weekly and monthly charts.

If the fiscal crisis is resolved or put off to another day, and holiday sales are good, there is no bad news from the crisis in Europe and no wars with Iraq or Syria, the chart will probably break above the triple top and put a new high in place. This would confirm the positive upward pattern of higher highs, at least until April, when the best six months in the stock market comes to an end. The only pullback would be another test of the 200-day uptrend. Technicians will be looking at their charts for the weight of evidence in buy or sell signals created by demand and supply. They won't be swayed by the news stories but only the supply and demand created by those news stories.

THE DAY TRADER IS TRYING TO DODGE THE FISCAL CLIFF NEWS

We now turn to the day trader's nightmare living with the fiscal cliff breaking news and the intraday chart of minute-by-minute trading. Every announcement from Congress about the fiscal cliff drives the market up or down. Day traders could be blind-sided at any time with bad news on the fiscal cliff negotiations. The trader is leaning to the upside because, short-term, based on the daily chart, the signals are up as the SPY moves up from oversold to overbought. Thus, the strategy could be to buy every time there is bad news on the fiscal cliff. After the bad news, there always seems to be some good news to take the SPY back up. According to the *Stock Trader's Almanac* December is usually the #1 month in gains for the S&P but in

presidential election year it slips to #3. Now let's see what the day trader is seeing in the 5-minute chart.

DAY-TRADING 5-MINUTE CHART (EXHIBIT 19.5)

Exhibit 19.5 shows the 5-minute chart for the closing hours of December 5, 2012, and all of the trading day for December 6. What immediately jumps out from the price pattern for December 6 are the two moves up that a day trader would like to play. The first begins at around 10:30 A.M. on December 6 as price bottoms at $141.16 and later tops out at $142 at near 11:30 A.M. The day trader would be in and out several times on this move up, each time price weakens on this move up. The day trader is not trying to catch the top and the bottom of this move but rather possibly 10 cents on each trade. The high-frequency trading (HFT) algorithms will trade for less than a penny profit.

The small day trader is watching the trade-by-trade volume and price that are forming with the 1-minute candlestick and volume. He is looking at the trade-by-trade chart to spot the support and resistance levels in price. He will be looking for reversal candlesticks such as the hammer at support or the hanging man at resistance. He will only glance at the 5-minute overview of Exhibit 19.5 to lean bullish or bearish, but he will be making the trading decisions based on the trade-by-trade chart forming on his screen. He is reading the raw data of supply and demand. Those seeing the order flow before it hits the tape have an advantage.

The HFT robots will be making decisions based on the rules programmed into their algorithms. The day trader with a brain and fast reflexes is smarter than the HFT robot, but the robot is faster in executing large numbers of trades in a short period of time. The robot has no emotions and that is a big advantage in trading. Some day traders will be using computer trading systems that are giving them buy and sell signals and they have the option to trade these signals mechanically. Other traders will allow the system to make the trades much like the HFT algorithms, except they have the option to stop the trades at any time.

In Exhibit 19.5, you can see the buy and sell signals that will provide the overview for the trade-by-trade decisions he is executing. The novice day trader, trading at a much slower pace than the professional, will be able to use this chart to make trades. The novice may be happy to reduce risk by using more reliable but less timely signals to make only one trade on the way up for 10 or 20 cents.

If you go to Exhibit 19.5, you will see we have drawn a blue "buy" line down the whole page as well as a "sell" line in red. These buy and sell lines

EXHIBIT 19.5 SPY, December 6, 2012, Intraday, 5-Minute
Source: StockCharts.com.

are keying off the buy and sell signals flashed by the MACD signal at the top of the page. We are going to compare every other buy and sell signal on the chart with this standard. The novice may be happy with this signal, but the professional is looking for an earlier and leading signal that will put him ahead of the novice.

Using the MACD signal alone, which we do not advocate, would have seen a day trade buy near $141.65 and out by $141.75 for a 10-cent profit. This is the way an algorithm would do it if it were only using one factor, but they use more than one factor. Trading systems for the individual using only the MACD would work this way, but most trading systems would also use more than one factor. We advocate using a weight of evidence approach by going down the buy and sell lines on the chart to see what the other signals are saying. We have labeled each signal from "A" to "J" and will now examine each in detail.

TRADER'S BUY SIGNALS (BLUE LINE IN EXHIBIT 19.5)

A. This is the MACD buy signal that determines the blue line running up and down the chart. It consists of a buy signal when the histogram bars break above the horizontal line. Likewise, when the black MACD line breaks above the slower-moving 9 EMA in red. You will see at point C that the stochastic signal is better and earlier. The slower MACD signal may be better suited for the novice trader. The professional trader wants the earlier signal such as the stochastic and is willing to take more risk with the signal reversing quickly. In the case of the MACD, we have circled in blue the 30 minutes leading up to the blue line buy signal. The professional trader would look to act on the improving signal before the actual buy signal. You can see the slope of the MACD black line bottoms and begins to turn up before the buy signal is triggered. The professional would buy this bottoming action in the signal. Also, if you look at the MACD histogram signal you will see the bars below the line are improving. The professional would use this improvement to trade ahead of the actual buy signal. The professional can quickly reverse his trade if the buy signal fails to appear.

B. This is the RSI signal, and you can see it improving in the 15 minutes before the blue line MACD buy signal. This, in conjunction with the improvement in the MACD before the blue line buy signal, would encourage the trader to open his position before the buy signal.

C. This is the full stochastic buy signal, and you can see it is about 15 minutes before the MACD blue line buy signal. This enables the trader to open his position at a lower price than the MACD signal. If you look to

the left of point C, you will see the stochastic bottoming above the 20 scale marker. This is positive because the signal does not break down below 20, which would be a sign of stronger selling taking the signal into oversold territory. Thus, the trader is encouraged to trade earlier than even the early stochastic buy signal. He would be encouraged to trade the hammer candlestick reversal signal marking the very bottom of price. In other words, the professional trader could open his position at the bottom.

D. This point on Exhibit 19.5 is a very important support level for the trader called the pivot point, identified with a P in a box on the chart. If the trader is leaning bullish on the SPY, he expects this important price level to hold. The previous test of the pivot point, right after the open of trading on December 6, held and price bounced so this would encourage the trader to open a position as the pivot point is being retested. The trader would be proactively ready to buy as soon as the 5-minute hammer candlestick appeared on the screen, a reversal signal at $141.40, which would give him a 60-cent profit to the top at $142.00. As you know, we don't expect to catch bottoms or tops, so the trader would have netted something less on this trade.

E. This is the famous hammer candlestick reversal signal. It coincides with the blue line buy signal coming down from the full stochastic buy signal. Traders would be all over these two buy signals which appear ahead of the MACD blue line buy signal that stretches up and down the whole chart (Exhibit 19.5). The Hammer candlestick is identified by the price label on the chart of 141.160 at point E. This is the low price hit by the wick, shadow, tail line stretching down from the white hammerhead on the hammer candlestick. By the time the hammer candlestick appears on the trader's screen, price has already moved up from the low of $141.16 to the top price of the candlestick of about $141.40, which is the price we noted earlier in (D) for opening the trade.

F. This identifies a little spike in positive volume, taking price up when the Hammer candlestick appears. The traders did not miss this buy signal.

G. You can see the uptick in CMF during the 10 minutes before the MACD blue line buy signal standard we are using in Exhibit 19.5.

H. OBV moves up sharply during the 15 minutes before the MACD blue line buy signal.

I. The KST buy signal, with the KST black line breaking above the slower moving EMA line, coincides with the MACD buy signal. Like the MACD line, the trader would have noticed the improvement in the slope of the

line as it bottomed and turned up before the signal. This mathematical improvement in slope of the line could also be captured or "seen" by an algorithmic HFT program.

J. The Aroon is a lagging indicator and is still very useful. The trader wants to buy at the bottom of a trading move up. The Aroon in this case identifies the bottom. For some contrarians, that would be an automatic buy. Traders prefer to be contrarians, buying on weakness and selling into strength as the novices do just the reverse.

TRADER'S SELL SIGNALS (RED LINE ON EXHIBIT 19.5)

The trader' sell signals are just the reverse of the buy signals outlined in great detail earlier. We will review these sell signals in less detail because the signals are now obvious compared to the buy signals. The trader will use the sell signals, or the approaching sell signals, to close his long position and open a short position to profit from the anticipated drop in price after the sell signals.

- MACD, in Exhibit 19.5, establishes the red line going down the chart as the sell signal. However, once again the stochastic gives an earlier sell signal. Also note, the advance warning of the MACD sell signal as the histogram is dropping for the 20 to 30 minutes before the sell signal is triggered. This advance signal is of great interest to the trader so he can short ahead of the MACD signal.
- The RSI starts dropping about 15 minutes before the red line MACD sell signal.
- Sell signal by the stochastic is earlier and better than the MACD sell signal, and we draw another red line down to price to show the difference.
- The downtrend in the CMF provides ample warning of the coming sell signal. It turns into the red about 5 to 10 minutes before the MACD red line sell signal.
- OBV provides a long downtrend line before the red line sell signal. Along with CMF and the MACD histogram, these negative divergences to price moving up give ample warning of the approaching top in price and the eventual sell signals before and at the red line.
- The KST sell signal is right on the red line. For 10 minutes before the signal, you can see the KST line rolling over. This change in slope before the actual sell signal can easily be caught mathematically by algorithmic HFT robot programs.

- At the bottom of Exhibit 19.5, the lagging signal, the Aroon shows the topping process that traders like to short. Traders have to sell before this drops. When it drops, it means it is too late to trade on the short side, unless the news is so bad that the downside move is going to be enormous.

SUMMARY

In this final case study chapter, we have shown the panoramic view of using technical analysis whether you are a portfolio manager, an investor, a hedge fund, or a day trader. Whether you are using a 20-year monthly chart as a long-term investor or a 1-day 5-minute chart as a trader, the successful use of technical analysis signals are here to see, learn and use because they improve performance for portfolio managers as well as traders. The case study is the S&P 500 Index using the SPY charts as a surrogate to the index. The SPY can be traded just as you trade the shares in any stock. The market charts, such as the SPY, seem to be the neutral ground where fundamentalists and technicians can meet and share the performance benefits of technical analysis with an open mind.

Successful Stock Signals for Traders and Portfolio Managers: Integrating Technical Analysis with Fundamentals to Improve Performance, Thomas K. Lloyd, Sr.

About the Companion Website

Please visit www.wiley.com/go/stocksignals (password: stock789) to access additional indispensable information to use alongside this book. There, you will immediately be able to pull up updated charts that will currently show the signals and price movements since the original charts were placed in this book. Thus, this text, the exhibits, and the signals become ageless, and you will be able to continue tracking them uninterrupted by time.

In addition, you will constantly want to refresh your memory on the exact definition of the signals and terms that are being used in this book. To accomplish this, we provide a detailed definition of terms on the website. In addition to our definitions, there is also a link to the more extensive definitions found on StockCharts.com. StockCharts.com has an excellent "chart school" and detailed mathematical explanations of the signals.

Finally, due to space constraints in the book, links to many articles that need to be read in their entirety are included there. If you are using the case study method, these articles are important preparation for your conclusions in the case study. These articles are especially useful for students and teachers using a case study approach to learning from the text. Links to important websites are also included that provide enormous background articles for an individual stock discussion.

Learning should be fun, so have fun using the following links to annotated charts and additional websites when you visit www.wiley.com /go/stocksignals:

- Links to updated charts (numbered as they appear in the original text).
- Technical analysis signals and terminology defined, A to Z.
- Links to articles by Tom Lloyd as referenced in the text.
- Tom Lloyd's Meetup.com page.

Successful Stock Signals for Traders and Portfolio Managers: Integrating Technical Analysis with Fundamentals to Improve Performance, Thomas K. Lloyd, Sr.

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Tom Lloyd Sr. worked in marketing for the specialist firm Adler Coleman, the fundamental research firm Woolcott Research, the institutional broker Hoenig & Co., the chart service Flow of Capital, trader Al Grolimund's Fair Market Profile, and the registered investment adviser F. Martin Koenig Advisors L.P. Currently, he markets quantitative and technical analysis research to institutional investors. Tom has an MBA in accounting and taught the course "Invest with the Best" at St. John's University, using an integrated fundamental and technical approach. His articles have been published in *Technical Analysis of Stocks and Commodities* magazine, SeekingAlpha.com, and the Trading Deck on MarketWatch.com. Tom has spent his Wall Street career working with institutional portfolio managers and traders using both fundamentals and technical analysis to improve performance by rotating into stocks outperforming the markets.

Tom's MBA thesis was on operational auditing. His articles in *Technical Analysis* magazine were "Proactive Trading," "Daily Stock Technician," and his inefficient market theory "Looking for Inefficiently Priced Stocks." His most recent articles are archived on MarketWatch.com. He is on Twitter @tomlloyd12.

Successful Stock Signals for Traders and Portfolio Managers: Integrating Technical Analysis with Fundamentals to Improve Performance, Thomas K. Lloyd, Sr.

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